THE MILKEN INSTITUTE
Review
A JOURNAL OF ECONOMIC POLICY
SECOND QUARTER 2004

What if the sky really *is* falling?

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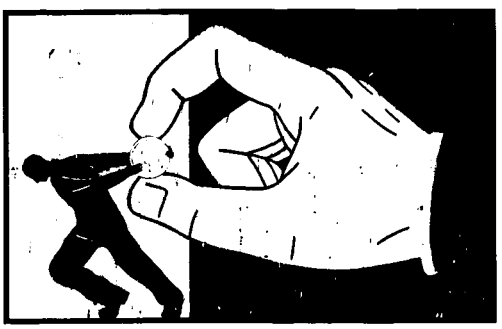

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FROM THE PRESIDENT

As we put this issue of the *Milken Institute Review* to bed, we are also putting the final touches on our biggest event of the year – the Milken Institute Global Conference in Los Angeles, now in its 7th incarnation.

As the conference has grown in size and stature, it has become a significant meeting place for business, financial, academic and public policy leaders. They not only get a chance to hear new thinking on current issues, but also to interact with an incredibly diverse and accomplished group of individuals.

Bringing such a rich mix of people together is one of the hallmarks of the Institute. As an independent, nonpartisan think tank, we work hard to ensure that all voices – from the left and the right, from a wide spectrum of occupations and industries – are heard at our events. By the same token, both our research and the contents of the *Review* reflect our commitment to a wide range of viewpoints.

Such diversity can set off a wonderful intellectual chain reaction of original thinking. And that's just what we want. This cross-fertilization of ideas is important as we deliberate some of the tremendous challenges and changes facing us – from the growing economic clout of China to the bitter debate over outsourcing and jobs.

Recent work here at the Institute, and many of the sessions now being planned for this year's Global Conference, focus on the touchstone issues of the day. They include questions of coping with terrorism, of maximizing technological innovation while minimizing the negative side effects, of the job skills gap that has widened income inequality, of speeding medical research, of the social and fiscal impact of rapid population aging, and of increasing the efficiency of capital markets both to maximize economic growth and to open business to minorities.

Which brings me back to the *Review*. This issue captures many of these debates, as well as our effort to encourage a thoughtful discussion of these policy concerns. As with every issue, this one offers fresh views on a host of topics – everything from the long-term impact of religion on economic growth, to the prospects for the dollar, to the possibility of fiscal bankruptcy in the United States.

Enjoy.

Michael Klowden, President and CEO

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It's been an interesting few months here in Lake Wobegon. The lunch bunch at the Chatterbox Café was hospitalized briefly – seems they came down with *e coli* from the meat loaf special. And Pastor Lindquist was almost forced to step down after two members of the fellowship youth were caught with a bottle of peach schnapps on the group's annual overnighter in the Twin Cities.

Wait; wrong intro. This is Santa Monica, where all the children really are above average. And the publication is the *Milken Institute Review*, your quarterly feast of economic policy. In this issue:

Larry Kotlikoff of Boston University lays out the long-term fiscal consequences of tax cuts combined with hefty new government obligations.

"With the new drug benefit," Kotlikoff writes, "the fiscal gap now totals roughly $51 trillion. Roughly speaking, that's five times the United States' GDP and – perhaps most chilling – far larger than total U.S. private wealth."

"Coming up with $51 trillion through any means will be extraordinarily unpleasant," he adds. "One way would be to raise federal personal and corporate income taxes immediately and permanently by 78 percent. Another option would be to cut all Social Security and Medicare benefits in half."

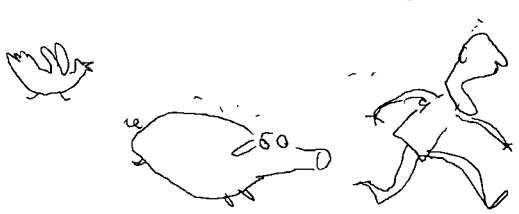
Catherine Mann of the Institute for International Economics in Washington explains how America's ballooning trade deficit is likely to affect global economic stability and prosperity.

"Several factors point to the reality that other countries have a vested interest in large and chronic U.S. trade deficits – that the U.S. deficit persistence is linked to global co-dependency," she writes. They have made "a bargain with the devil in the sense that when their own currencies eventually do appreciate, not only will their exports fall, but so, too, will the value of the dollar-denominated assets in their portfolios."

Robert Barro and **Rachel McCleary** of Harvard take a new look at a very old debate: the relationship between economic growth and organized religion.

"The main impact of religion on growth is a positive response to an increase in believing relative to belonging (attending)," they write. "We conjecture that religious beliefs stimulate growth because they help to sustain aspects of individual behavior – honesty, thrift, work ethic – that enhance productivity."

"Note that our statistical estimates do not imply that greater church attendance has a net negative influence on economic growth.



SERGE BLOCH

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Rather, the net effect depends on the extent to which an increase in attendance leads to stronger beliefs. Having many religious holidays or requiring congregants to attend services does not necessarily translate into more believers."

John Crudele, an economics writer for *The New York Post* and **Walter Williams**, an independent economic consultant, offer a novel way to supplement fiscal and monetary stimulus in an era of mega-deficits.

"In addition to cutting interest rates or taxes," they suggest, "Washington could offer people limited-time-only access to their retirement savings accounts without penalties or tax consequences. This would augment private spending when the economy needs it, increasing demand directly for consumer goods and indirectly for new productive capacity."

Jared Bernstein of the Economic Policy Institute in Washington gets up close and personal with the living wage movement – the grassroots effort to raise minimum wages to the level needed to support a family.

"Living wage provisions are now in effect in more than 100 cities, counties and other entities, such as universities, and the pace of adoption seems to be accelerating," he notes.

"By remaining limited in their coverage, their advocates have been able to convince city officials – and by proxy, taxpayers – that they will accomplish their stated goals without leading to significant layoffs, tax hikes or reduced competition for contracts.... But the marginal coverage of the policy limits its impact to raising the living standards of a tiny fraction of America's working poor."

John F. McDonald, an economist and dean at the University of Illinois's Chicago campus, takes on the fashionable view that American society is going to hell in a handbasket.

"Yes, the decade of supercharged economic growth and vanishing unemployment seems a distant dream," he writes. "But, believe it or not, many of the social and economic challenges that seemed so formidable a few decades ago are becoming more manageable. And – dare I say it – the liberal dream of progress in America is alive and well."

Jim Barth and **Rob Koepp** of the Milken Institute, writing with **Zhongfei Zhou** of Shanghai University, offer a progress report on long overdue bank reform in China.

"Lately it has become fashionable to predict that China's non-performing loan problem will gradually eat away at the economy's performance. While critics are right to be concerned, they ignore the potential upside from successful banking reforms. Indeed, we believe that China's banking sector has the potential to catalyze the next steps in the economy's ongoing transformation."

And don't forget the extras – an idea from Nobel Prize-winning economist **Gary Becker** on how to shorten the pipeline to life-saving pharmaceuticals, an excerpt from journalist **Matt Miller**'s book, *The Two Percent Solution*, and a charticle from the Institute's very own demographer, **Bill Frey**. Happy reading.

— *Peter Passell*

WILLIAM RIESER

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BY CATHERINE L. MANN

In a world grown blasé by big numbers, here's one still big enough to stand out: The United States' current account balance deficit – the broadest measure of our annual trade and investment relations with the rest of the world – is roughly one-half trillion dollars in the red per year. Can America continue to suck in the torrent of cash needed to cover deficits of this magnitude?

Can the current account be narrowed sufficiently to generate a soft landing, or will the exchange value of the dollar crash, even as trade and investment flows become hostage to rapidly changing market sentiments and government responses?

America's current account, which largely mimics the difference between exports and imports of good and services, has been in deficit for almost a quarter-century. Now, by definition, an economy running a current account deficit will, one way or another, experience a net capital inflow that mirrors the deficit as foreigners accepts a country's financial assets in exchange for its purchases. But analyzing the consequences of the current account deficit and the corresponding net capital inflow is not so easy, because how we got to where we are is all about composition – about the types of products we buy and the types of financial assets we give in exchange.

Running a current account deficit can mean a country is living beyond its means – that imports exceed exports because overall consumption and investment exceed national savings. Or robust capital inflows can mean that a country is viewed as an oasis of prosperity and stability, attracting investment from around the globe because its economy delivers higher returns at lower risk than other venues do. There's a third possibility: a country's large current account deficit and capital account inflow can be caused (or at

CATHERINE L. MANN is a senior fellow at the Institute for International Economics in Washington. Readers with an appetite for more analysis may wish to read her papers, "Perspectives on the United States Current Account Deficit and Sustainability," *Journal of Economic Perspectives* (2002) and "How Long the Strong Dollar?" in John Williamson and C. Fred Bergsten, eds., *Dollar Overvaluation and the World Economy*, Institute for International Economics (2003).

AP/WIDE WORLD PHOTOS

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least exacerbated) by trade and investment partners' economic policies that stymie efforts to balance international accounts. How one sees the prospects for the United States current account (and the exchange value of the dollar) is linked to how much weight one puts on each of these not-mutually-exclusive interpretations of cause and effect.

HOW DID THE CURRENT ACCOUNT DEFICIT GET SO BIG?

The current account is driven predominantly by trade in goods and services, which in turn is largely determined by U.S. and foreign income growth, along with the exchange value of their currencies. Underlying the $540 billion current account deficit in 2003 is a deficit on trade in goods and services of about $490 billion.

United States exports grow faster when foreign income grows faster and when the dollar depreciates. Conversely, U.S. imports grow faster when U.S. income grows faster and when the dollar appreciates. So movements in the U.S. trade balance are greatly influenced by the degree to which the U.S. and foreign economic cycles are out of synch.

In the early 1980s and again in the early 1990s, the American economy slipped into recession and imports slowed. World growth remained robust, so U.S. exports rose. For both reasons, the trade deficit narrowed. In the late 1990s and early years of the new century, though, anemic growth in Japan and Europe dampened demand for United States exports, while appreciation of the dollar relative to the euro and yen made imports more attractive to Americans. Hence, until quite recently, both income and price factors tended to widen the U.S. trade deficit.

Structural factors have also worked to widen the trade deficit. One such factor is Americans' lusty appetite for foreign products: U.S. imports expand more rapidly when we grow than U.S. exports grow when foreign economies are on the upswing. Moreover, simply as a matter of arithmetic, once America has a big trade deficit, proportional growth of imports and exports increases the absolute dollar value of the deficit. Since imports are now about 50 percent greater than exports, that is a deep hole to climb out of.

Here is where the composition of trade starts to matter. The biggest trade deficit hole is in consumer goods and autos, where there is a persistent, long-term trend toward deficit that was exacerbated both by robust personal consumption growth in the United States during the go-go 1990s that endured even as the economy slipped into recession, and by the recent tax-reduction-led recovery in consumer spending. In addition, services such as ocean transport, which is tied to the U.S. import boom, and, more recently, outlays related to anti-terrorism and the war in Iraq, have added sharply to the trade and current account deficits.

On the other hand, America's competitiveness in services shines through. The balance on trade in what the bean counters call "other private services" – education, finance, and business and professional services – is persistently positive, and the surplus has continued to rise despite slow economic growth abroad.

Finally, one of the bigger puzzles in recent years is the balance of trade in capital goods, and industrial supplies and materials. Until 1997, this balance cycled through larger and smaller surpluses, depending on global business conditions. Since that year, however, the trade balance in this category has deteriorated from a surplus of about $50 billion to about zero.

In sum, the current account deficit has ballooned for a host of reasons. Any signifi-

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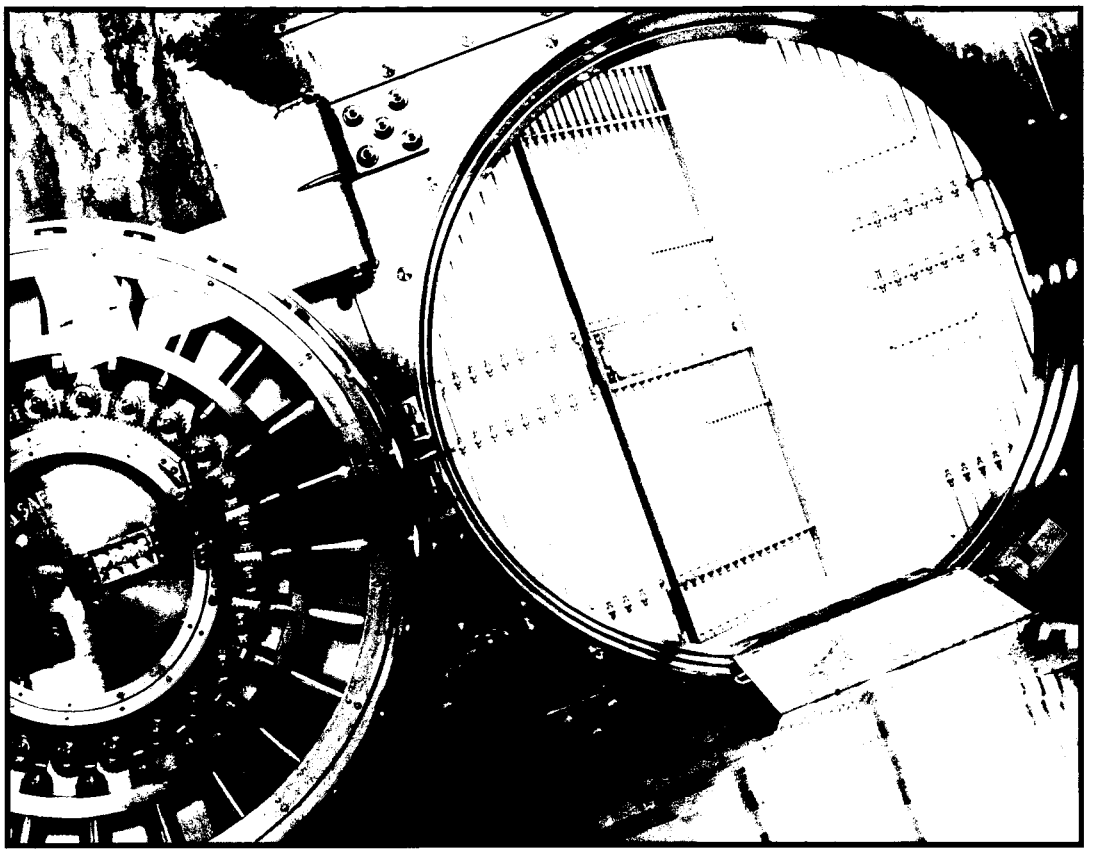

GETTY IMAGES

cant change in the trajectory of the United States current account depends, at a minimum, on changes to policies underpinning both growth prospects and exchange rates. But, given the composition of trade, only draconian changes would be likely to make a big dent in the deficit.

HOW BIG A CURRENT ACCOUNT DEFICIT IS TOO BIG?

By the mid-1980s, the accumulation of the current account deficits financed by foreign capital inflows transformed the net international investment position of the United States from positive to negative. That is, foreign investors now hold more in U.S. assets than United States investors hold in foreign assets. By the end of 2002, the net international investment position of the United States economy was $2.7 trillion in the red.

The net international investment position bears on the question of the sustainability of the current account deficit and the associated inflow of capital. Big liabilities today increase the rate of growth of liabilities tomorrow; the large stock of financial obligations implies outflows of interest, dividends and the like that must be paid out of the economy's current production.

Note, too, that the awesome net investment position of foreigners means that even a dominant economy like that of the United States must consider the consequences of a change in foreign investor sentiments about the desirability of holding dollar assets in their portfolios and continuing to provide

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the net inflow of financial capital needed to offset the U.S. trade deficit. But, here again, composition matters.

Taking a United States-centric view of "bigness," the current account deficit and its accumulated negative net international investment position are not daunting because foreigners (a) seem inclined to hold onto dollar-denominated financial assets, (b) seem to like buying assets that do not demand an immediate return (stocks), and (c) have an appetite for low-yield U.S. Treasury securities. With nobody beating on the door for repayment – indeed, with foreigners throwing more money at us than we need to cover our foreign spending – there is little incentive to alter our inclination to consume and import, and thereby to change the trajectory of the current account.

With foreigners throwing more money at us than we need to cover our foreign spending, there is little incentive to alter our inclination to consume and import.

Taking a more global view of bigness, the $540 billion net inflow of capital, along with the trajectory of net capital flows that will be needed to cover the external deficit, looms larger. Domestic economic conditions aren't the only factors affecting the current account and the value of the dollar. Factors outside Washington control – growth in the global economy, financial leverage and how foreigners allocate their wealth according to preferences for risk, return and diversification – also have an effect.

In theory, a large and persistent current account deficit leads to an ever-growing negative net international investment position. And eventually, the imbalance is self-correcting. Financial payments (like interest and dividends) to foreigners become large enough to cut into domestic consumption and business investment. The current account deficit itself (and its accumulation) reduces domestic spending, which reduces import growth, which changes the trajectory of the current account toward a sustainable path. For industrial countries, a current account that reaches 4 to 5 percent of GDP is typically associated with economic forces – rising interest rates, slowing consumption and domestic investment – that begin to narrow the current account deficit.

America's current account deficit was about 4 percent of GDP in 2000 and 2001, then jumped to 4.6 percent of GDP in 2002 and 4.9 percent of GDP in 2003 – a new record. But these external imbalances have not yet caused a financial pinch. In fact, even though the net international investment position turned negative in the 1990s, the United States still earned $16 billion more in interest and dividend payments than it paid out in 2003. Moreover, interest rates remained low and consumption strong through 2003.

How can the United States have a negative net investment position, yet not pay more to service financial obligations than it collects? More broadly, why is the 5 percent current account deficit apparently not generating economic forces that narrow the deficit?

A key factor here is the composition of foreign purchases of U.S. assets. Most of the private capital flowing into the United States consists of foreign direct investment and portfolio investment, neither of which require

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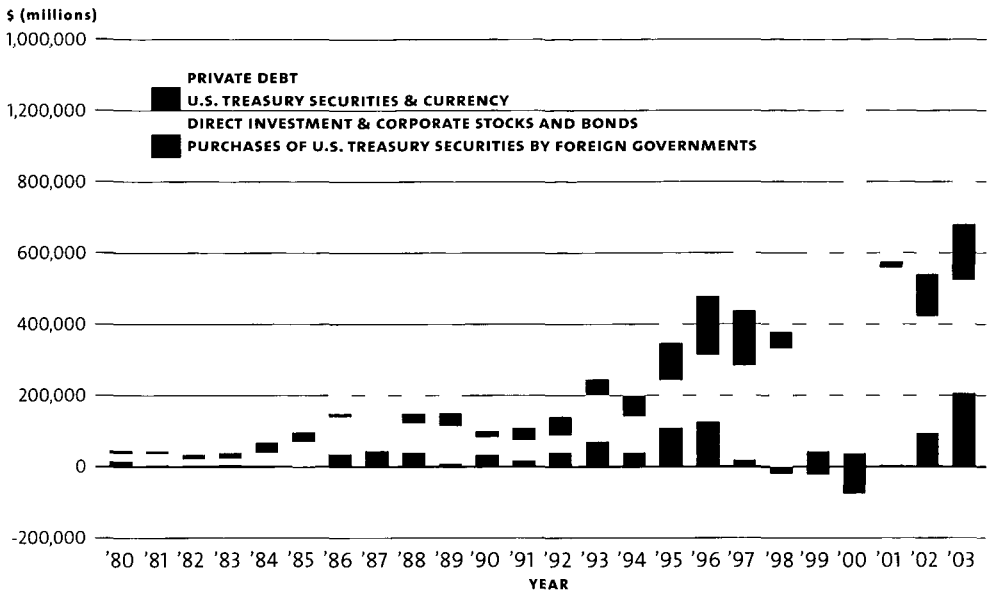
FOREIGN PURCHASES OF U.S. ASSETS BY MAJOR ASSET TYPE



regular fixed payments to maintain, as is the case for bank loans. Moreover, the market-oriented nature of stock and bond investment means that if some foreign investors sold their holdings, asset prices likely would decline, motivating other investors to buy. Finally, U.S. entities borrow almost exclusively in domestic currency; more than 90 percent of their external debt to banks is in dollars, and most securities liabilities are denominated in dollars. Consequently, America can afford to carry a larger current account deficit than a country whose obligations consist primarily of short-term bank loans denominated in foreign currencies.

Even if the composition of U.S. obligations reduces the need for timely maintenance payments, the pressure to sell huge quantities of dollar-denominated assets to cover the current account deficit could drive down their price – that is, the exchange value of the dollar could fall. How much the global investor is willing to invest in dollar assets is determined by several factors, among them the costs of buying and selling, market regulation, and, of course, the American economy's prospects compared to those of other economies. Hence, estimating just how much global investors wish to hold in dollar assets is difficult. Moreover, it is not just the stock of global wealth that matters, but how fast global wealth is growing compared to how fast the supply of dollar-denominated assets offered into the international marketplace is growing.

Survey evidence from *The Economist* suggests that global investors increased the share of U.S. stocks and bonds in their portfolios from about 40 percent in 1992 to about 55 percent at the end of 2003. Increased holdings of dollar assets come from disproportionately large purchases of stocks and bonds as wealth grows. A calculation of the marginal investment allocation for recent years suggests that

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investment of new foreign wealth in dollar assets was quite modest in the early 1990s, doubled in the mid-1990s, and was just about the average share of equity portfolio holdings from 1998 to 2001.

This pattern is consistent with the changes in the average holdings of dollar assets observed in *The Economist* survey, as well as with factors generally believed to determine investor choices. First, it is consistent with the relative performance of the American economy in the late 1990s to the end of 2000. Second, it is consistent with the data on net foreign purchases of dollar assets, particularly during the bubble period in United States and global stock markets. Finally, in 2001 when collapse of equity valuations worldwide hit global financial wealth hard, the U.S. current account deficit conveniently narrowed, reducing the supply of dollar assets being fed into the financial markets.

Beginning in 2002, however, even though the share of dollar-denominated assets in global portfolios stayed high, the value of the dollar started to depreciate – particularly against the euro. The U.S. current account deficit began to widen again, but sluggish global growth translated into smaller increases in global wealth. Moreover, at least in the early months of 2002, differences between major stock market indexes in Europe and the United States narrowed as the prospective returns on United States assets seemed to be less attractive, and widening corporate scandals – think Enron, WorldCom and Tyco – increased the perception of risk associated with owning dollar assets.

All told, concerns over portfolio diversification, slow growth in global wealth, and a too-generous offering of U.S. assets to the marketplace, along with less attractive returns and higher perceived risk in U.S. investments, all help to explain why the dollar depreciated in 2002 and into 2003. But these factors don't help much to explain why the dollar depreciated against some – but not other – major currencies.

GLOBAL CO-DEPENDENCY

Several factors point to the reality that countries other than the United States have a vested interest in large and chronic U.S. trade deficits – that deficit persistence is linked to global co-dependency. First, some foreign governments chose to create fresh demand for dollars by doubling their purchases of United States assets in 2003, to a remarkable $208 billion. Second, the rate of dollar depreciation was much greater against some currencies than others – 20 to 30 percent against the pound, Swiss franc, Australian dollar, yen and euro, compared to 10 percent or less against most Asian currencies.

Why the intervention to curb dollar depreciation? Some governments are buying dollar assets in order to maintain export market shares in the United States. Their purchases reduce pressure on the dollar to depreciate against their own currencies, thereby making their goods more attractive to Wal-Mart and the like. This constitutes a bargain with the devil in the sense that when their own currencies eventually do appreciate, not only will their exports fall, but the value of the dollar-denominated assets they own will, too.

For various reasons, though, this bargain is viewed as worth the cost right now. Not the least of the reasons is that many countries are desperate to remain competitive with Chinese exports to the United States, and China has locked its exchange rate to the dollar. But it also follows from Asia's born-again commitment to export-led growth in the wake of the 1997 financial crisis. To these countries, the financial crises proved the folly

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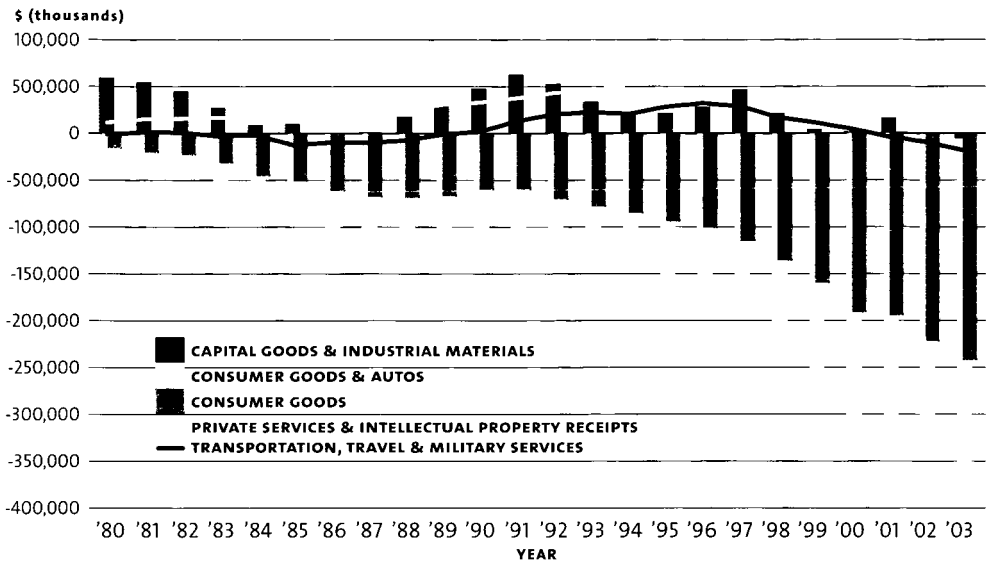
U.S. TRADE BALANCE: MAJOR COMPONENTS



of a domestic-led growth strategy and turned them back to time-tested export-oriented growth strategies.

This has tended to dampen American exports at a moment in which global growth is increasingly important for U.S. producers of capital goods. At the same time, low interest rates and the expansion of buying power associated with the big tax cuts in the United States is keeping U.S. import growth strong – particularly in consumer goods and autos, which remain relatively cheap because the dollar's depreciation has been slowed by Asian government intervention.

This, too, is a devil's bargain for the United States, in that the accumulation of both internal and external debt will lead to a day of reckoning. But Americans have so little experience with the consequences of excessive borrowing, particularly on international markets, that consumption today is enjoyed with little regard for the future.

How long can this global co-dependency go on, and what are the broader global ramifications of the current account imbalances? Severe global co-dependency creates significant currency-management issues. Third parties, notably the European Union, that have not sought to hang tough with the dollar will bear the brunt of dollar depreciation. The pressures on firms and workers dependent on exports will be intense, and aggressive macroeconomic stimulus will be required to offset falling demand for their exports. But global co-dependency could have a very long duration, and the imbalances created along the way will be difficult to unwind without precipitating a crisis of exchange rates, domestic growth, and international exchange of goods and financial assets.

Muddling through may seem a less-than-optimal approach to international public finance. In view of the political and economic constraints on policy in the America and abroad, however, it may well be the only practical approach.

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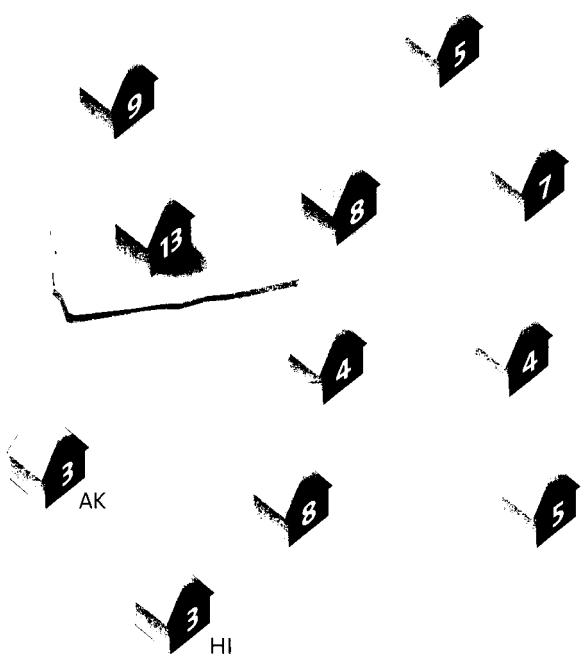
CHARTICLE

BY WILLIAM H. FREY

Just a year ago, the federal government introduced a new census concept – the "micropolitan" area – giving official status to the Mayberry RFD-type communities previously lost in the vast statistical wasteland outside metropolitan areas. While the name itself has spawned the predictable jokes (Will they form Micropolitan Symphony Orchestras? Will there be a baseball team called "The Mics?"), micro areas do offer a sort of validation to small-town America.

Not all, by the way, could serve as backdrops for old sitcoms. Some are enclaves for upscale exurbanites within commuting distance of big cities; others lure middle-income retirees with sunshine and cheap housing. Micropolitan areas range in size from 13,000 to 182,000 people, and are named after the most prominent hamlets – think Pahrumph, Nev. (near Las Vegas) and Mountain Home, Idaho. All told, the 560 micros are home to one American in ten.

Mississippi, Kansas and Iowa each have more micro areas than California, while highly urbanized Massachusetts, New Jersey and Rhode Island are micro-free. Micros generally gained population in the early 1990s, then lost some of it to hot metros like Seattle and Boise, then picked up a bit in the wake of 9/11. But it can be misleading to lump them together. Ninety-nine micro areas grew by more than a fifth over the 1990-2002 period, led by highfliers such as Palm Coast, Fla. (near Daytona Beach) and amenity-rich Branson, Mo. Meanwhile, another 110 micros in the South, Midwest and Plains states actually lost population.



Micro residents are generally older, poorer, more conservative, less educated and less

BILL FREY is a senior fellow in demography at the Milken Institute and a visiting fellow at the Brookings Institution in Washington.

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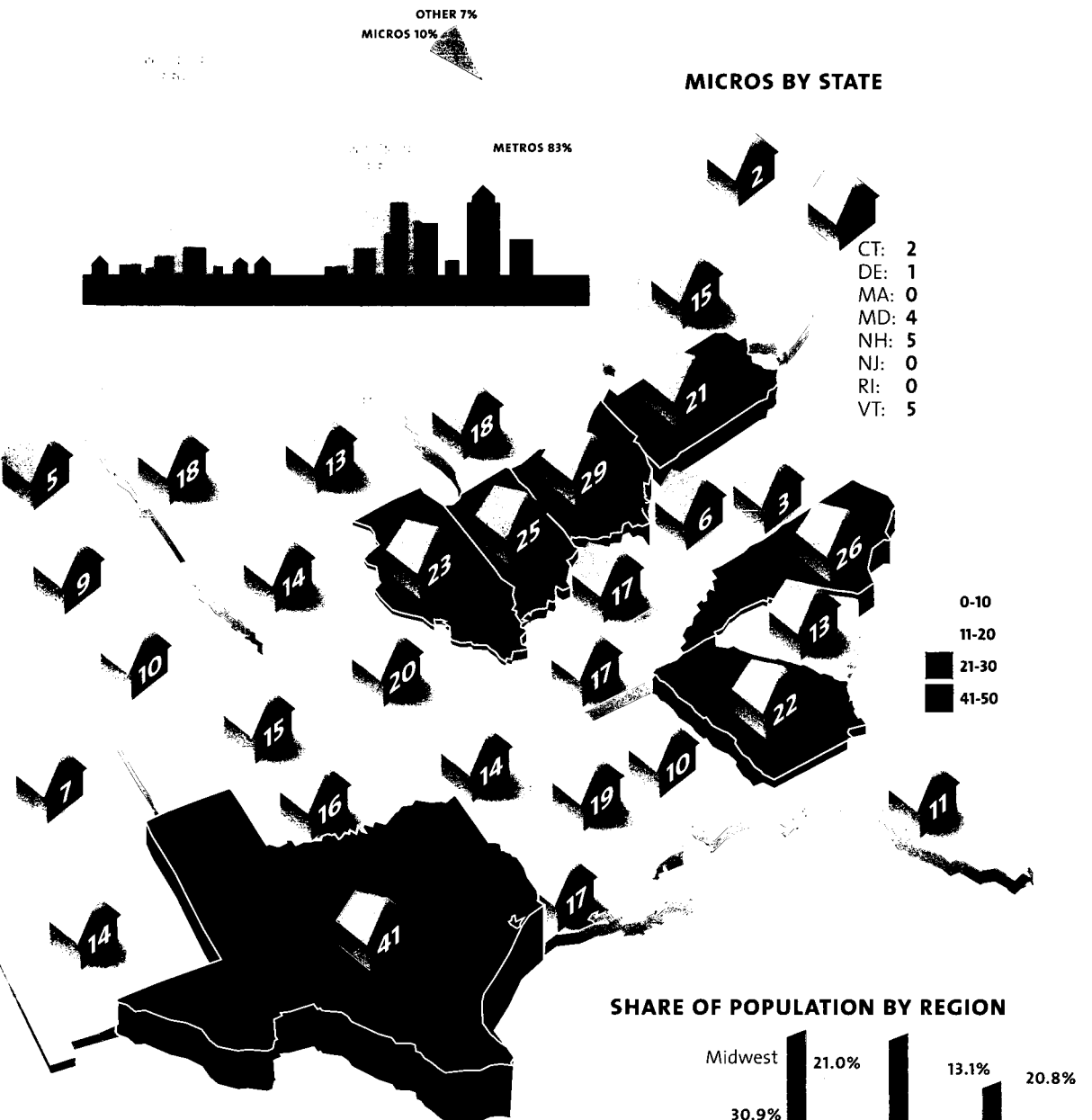
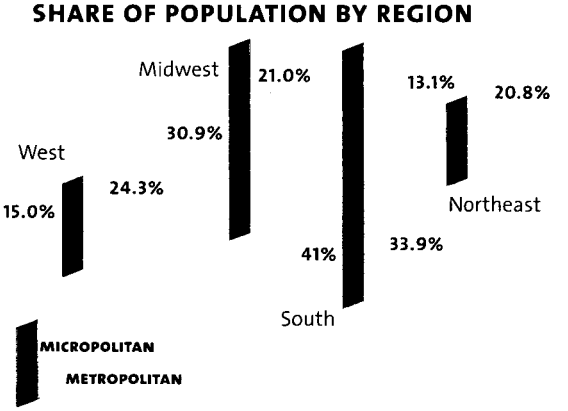
WHERE WE LIVE



diverse than their metro counterparts. But there are striking exceptions, including Jackson, Wyo. and Los Alamos, NM. Whatever they are, get used to hearing about them; a torrent of government statistics about them are coming your way soon. M

BRUCE SANDERS AND MAX HARLESS

SHARE OF POPULATION BY REGION



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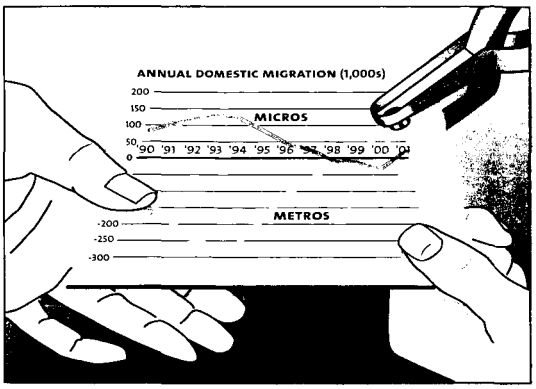
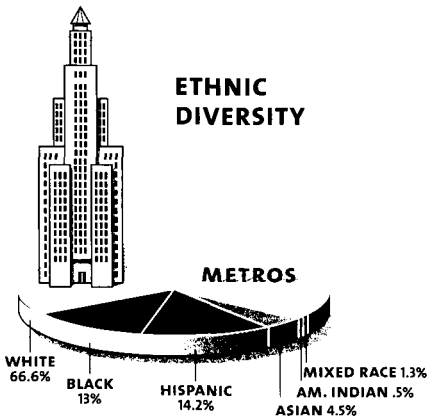
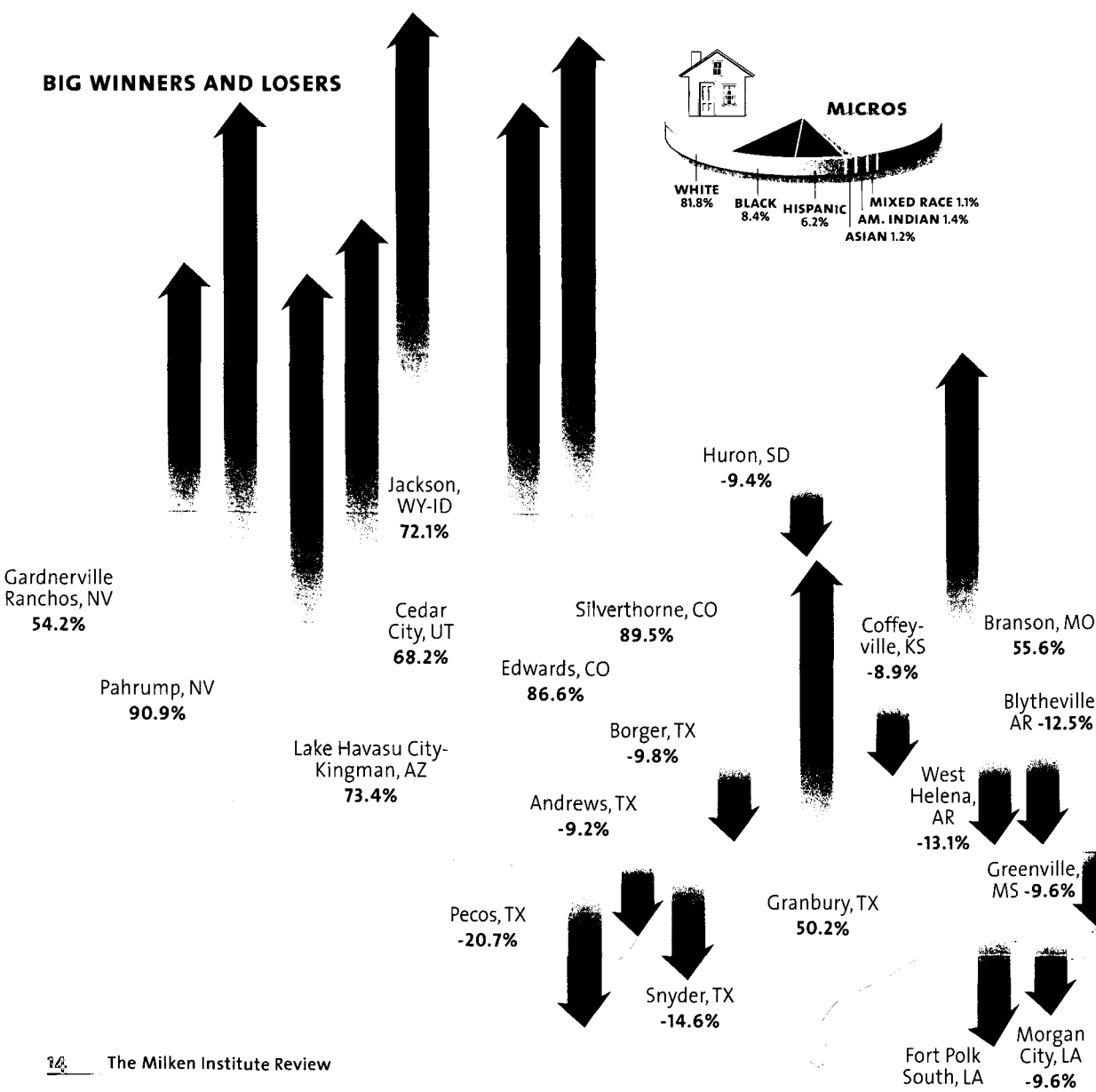
COMING AND GOING



ETHNIC DIVERSITY



BIG WINNERS AND LOSERS



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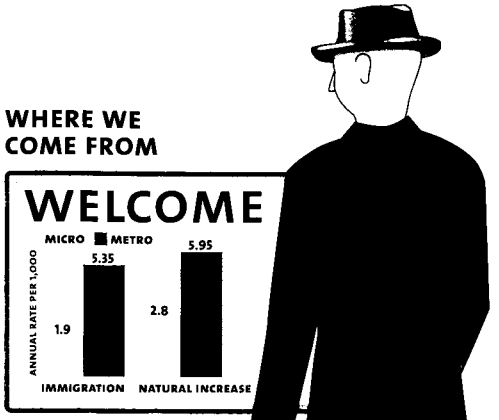
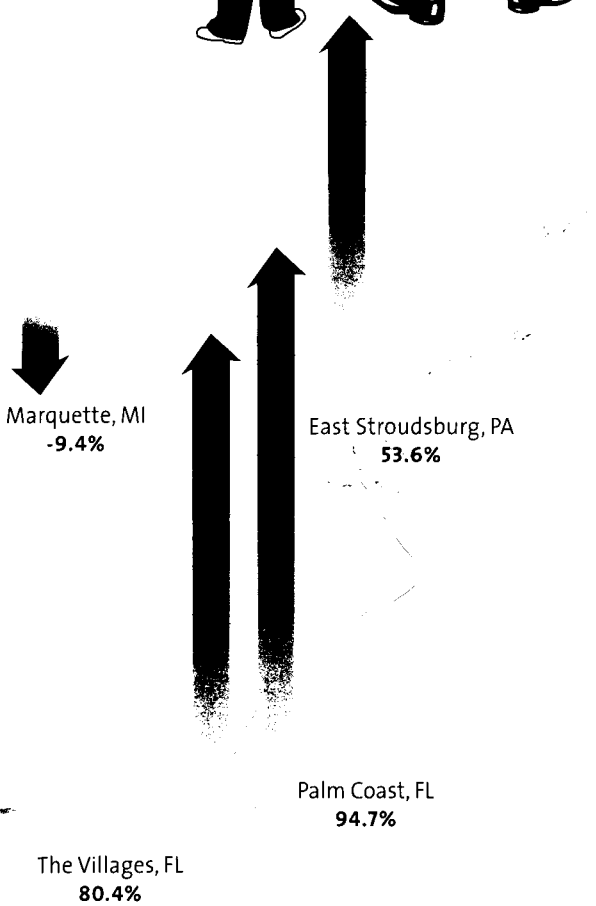


WHERE WE COME FROM



MICRO AREAS ARE OLDER, LESS UPSCALE AND MORE TRADITIONAL THAN METRO AREAS	MICROPOLITAN AREAS	METROPOLITAN AREAS
Percent Over Age 55	23.9	20.3
Percent College Grads	16.4	26.4
Percent HS Dropouts	22.1	18.8
Brains to Brawn Ratio*	0.74	1.41
Percent Mgrs and Professionals	27.0	35.0
Percent HH Incomes >$75,000	13.6	24.7
Percent HH Incomes <$25,000	35.5	26.8
Percent Married	57.3	53.6
Percent Widowed	7.5	6.4
Percent Single, Never Married	23.4	28.1

*Ratio of College Grads/HS Dropouts

OLDEST MICROS: MICROS WITH GREATEST 65+ POPULATION		YOUNGEST MICROS: MICROS WITH GREATEST UNDER 15 POPULATION	
AREA	PERCENT	AREA	PERCENT
Sebring, FL	33.0	Rio Grande City, TX	31.4
Homosassa Springs, FL	32.1	Eagle Pass, TX	31.1
Palm Coast, FL	28.5	Gallup, NM	30.9
The Villages, FL	27.4	Brigham City, UT	28.8
Mountain Home, AR	26.7	Nogales, AZ	28.7
Brookings, OR	26.6	Garden City, KS	28.5
Kerrville, TX	24.8	Blackfoot, ID	28.2
Southern Pines, NC	21.8	Dumas, TX	28.0
Brevard, NC	21.4	Hereford, TX	27.9
Port Angeles, WA	21.4	Elko, NV	27.7

EGGHEAD MICROS: MICROS WITH GREATEST COLLEGE GRAD POPULATION		DROPOUT MICROS: MICROS WITH GREATEST LESS THAN HS POPULATION	
AREA	PERCENT	AREA	PERCENT
Los Alamos, NM	60.5	Rio Grande City, TX	65.3
Silverthorne, CO	48.3	Eagle Pass, TX	57.9
Laramie, WY	44.1	Pecos, TX	53.4
Pullman, WA	44.0	Raymondville, TX	51.3
Jackson, WY-ID	41.9	Clewiston, FL	45.8
Bozeman, MT	41.0	Middlesborough, KY	43.4
Moscow, ID	41.0	Wauchula, FL	42.0
Edwards, CO	39.2	Del Rio, TX	41.3
Vermillion, SD	38.7	La Follette, TN	41.3
Durango, CO	36.4	Indianola, MS	40.7

MARRIED MICROS: MICROS WITH GREATEST PERCENT MARRIED		SINGLE MICROS: MICROS WITH GREATEST NEVER MARRIED POPULATIONS	
AREA	PERCENT	AREA	PERCENT
Los Alamos, NM	68.0	Starkville, MS	44.6
Palestine, TX	67.7	Pullman, WA	44.2
Palm Coast, FL	67.2	Mount Pleasant, MI	43.6
Lamesa, TX	67.1	Silverthorne, CO	43.4
Canon City, CO	66.5	Athens, OH	42.9
Granbury, TX	65.9	Carbondale, IL	42.4
Mountain Home, ID	65.7	Laramie, WY	42.3
Pampa, TX	65.7	Vermillion, SD	42.3
Crossville, TN	65.6	Indianola, MS	41.9
Mountain Home, AR	65.3	Oxford, MS	41.6

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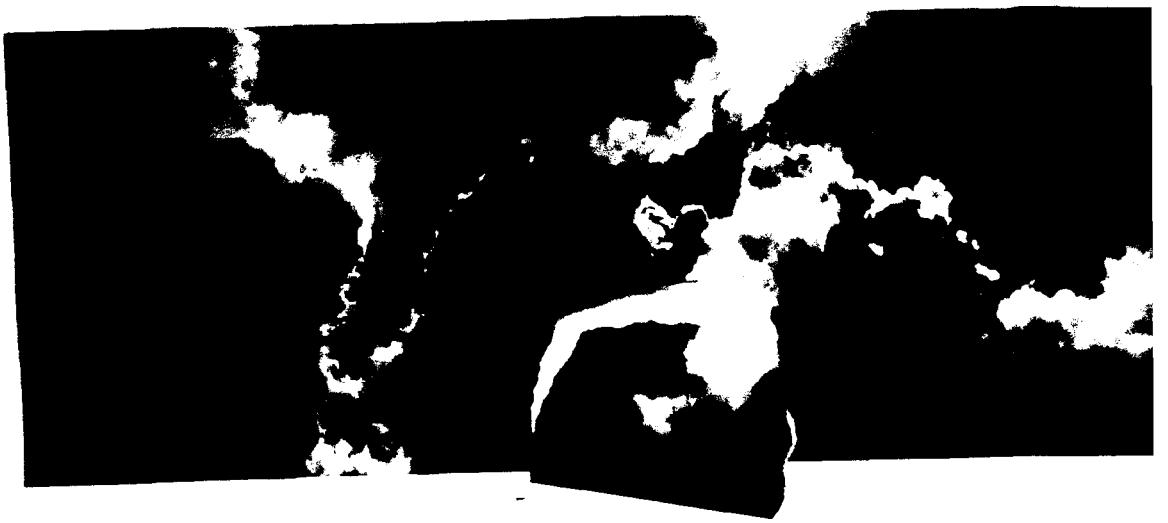

Aprèss Bush...

Thinking the Unthinkable

Months have passed since Congress enacted a hugely expensive Medicare drug benefit by a narrow margin. But two corpses are still rolling in their graves – those of Barry Goldwater and Lyndon Johnson. In championing the legislation, the Republicans trampled every principle of good governance that Goldwater, the conscience of conservatives, held dear. And in opposing the bill, Democrats allowed the party of Bush, Cheney and DeLay to take credit for the largest expansion of Johnson's cherished program in decades.

Yes, some Republicans voted against the bill, and some Democrats voted for it. But, on this one, most Republicans proved to be closet Democrats, and most Democrats, closet Republicans. In fact, the way the parties traded places was so remarkable that one might think they had experienced diametrically opposed epiphanies.

Think again. Had the Democrats controlled the White House and been in a position to claim victory rather than denounce the bill as not going far enough, the two sides would have switched their tunes and flipped their votes. These days, when it comes to economic policy, principle is passé and politics is king.

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Le Déluge?

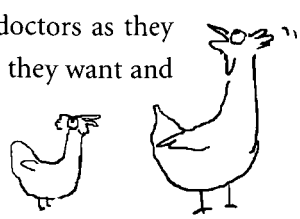
About Washington's Fiscal Mess

By Laurence Kotlikoff

Indeed, the key principle raised by this legislation – generational equity – was not only fundamentally violated, it was hardly discussed. Instead, the parties squabbled over the size of the freebie to give 33 million current elderly and 77 million baby boomers who are now reaching for their Lipitor. Pandering to these groups makes perfect political sense. Disproportionately divided, their 110 million votes can carry any election.

In an era in which much of the technological change in medicine is through pharmaceuticals, no one would dispute that the elderly need and deserve prescription drug insurance. But the next generation is in no position to pay for existing Medicare benefits, let alone the new benefit. No wonder a handful of thoughtful politicians on both sides of the aisle viewed the bill as myopic policymaking and refused to support it.

Unfortunately, the bill is worse than a mild case of myopia. It's a micro- and macroeconomic nightmare. At the micro level, it perpetuates Medicare's fee-for-service system under which the elderly can see as many doctors as they want as often as they want, have whatever medical procedures they want and



SERGE BLOCH (ALL)

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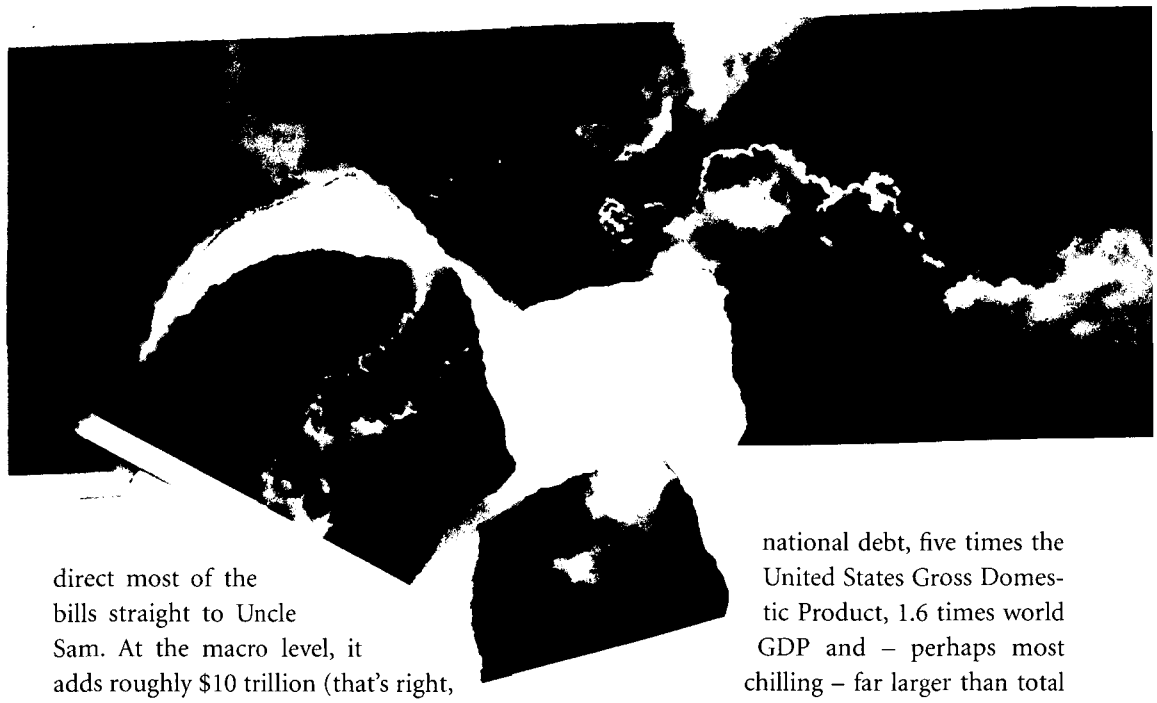

direct most of the bills straight to Uncle Sam. At the macro level, it adds roughly $10 trillion (that's right, *trillion*) to our long-term fiscal gap.

A TRILLION HERE, A TRILLION THERE...

The term "fiscal gap" refers to the difference between the federal government's future expenditures and future receipts, all discounted to "present value" terms in the same way actuaries calculate the net liabilities of private pension plans. Future expenditures include every payment the Feds make, from hunting down marijuana growers to paying Social Security benefits to servicing national debt. Future receipts include every dollar the Feds take in from income taxes, loan repayments – even snowmobile fees at Yellowstone.

With the new drug benefit, the fiscal gap totals roughly $51 trillion. Wrapping your brain around $51 trillion takes some doing. Roughly speaking, it's 12 times the nominal national debt, five times the United States Gross Domestic Product, 1.6 times world GDP and – perhaps most chilling – far larger than total United States private wealth.

The number is big for two reasons. First, thanks to the baby boom, the subsequent baby bust and the significant longevity increase we've experienced in the last few decades, our population is rapidly aging. Over the next 30 years, the number of elderly will double. In contrast, the number of workers available to pay their Social Security, Medicare and Medicaid benefits will increase by only 18 percent.

Note, too, that in addition to the entire country's aging, the elderly themselves are getting older. The oldest old – those over 85 – represent the nation's fastest growing age group. By 2050 this group would be large enough to populate all of New York, Los Angeles, Chicago, Houston and Philadelphia. And the number of centenarians – those 100 and older – will be able to fill up Washington, DC. Imagine walking around New York City and seeing only people 85 and older, and then traveling to Washington and see-

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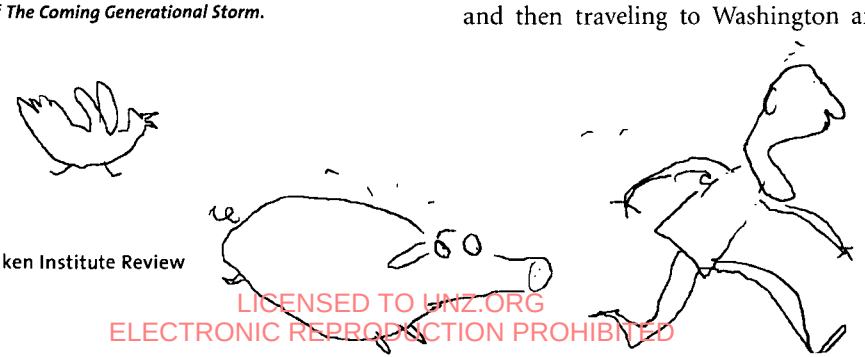

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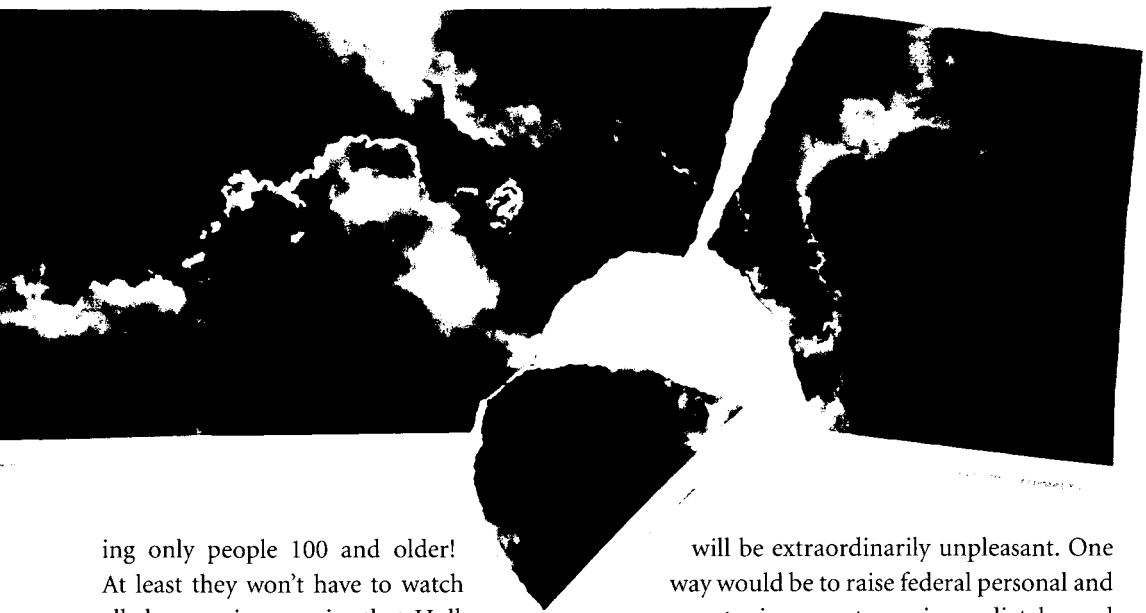

ing only people 100 and older! At least they won't have to watch all those action movies that Hollywood serves up to testosterone-addled adolescents.

Second, the elderly are very expensive. Taken together, Social Security, Medicare and Medicaid benefits currently total a whopping $23,000 per oldster annually. Worse still, this figure is sure to grow much faster than the wages of the workers footing these payments because the cost of medical services is growing rapidly and the consumption of medical services rises sharply with age (as well as with the availability of government insurance).

If a household's planned future expenditures on everything from groceries to car payments exceeds its future receipts when measured in terms of present value, that household is eventually forced to adjust its lifestyle. Either Mom and Dad are going to have to work and earn more, or the family is going to have to cut back on its spending. The situation for our government is no different. It, too, has to pay its bills.

CAN ANYBODY SPARE A DIME?

Unfortunately, coming up with $51 trillion will be extraordinarily unpleasant. One way would be to raise federal personal and corporate income taxes immediately and permanently by 78 percent. Another would be to eliminate all federal discretionary spending for all time, starting today. (Actually, this move would fall several trillion dollars short of the mark.) A third option would be to immediately and permanently cut all Social Security and Medicare benefits in half.

What about economic growth and immigration of young workers? Can't they bail us out? No way. Social Security benefits are explicitly linked to the level of real wages, while Medicare and Medicaid benefits are implicitly linked to wages. Hence, faster economic growth, which will spell higher real wages, means larger entitlements for all three benefit programs. Indeed, entitlement growth is disproportionately rapid – the absolute size of the fiscal gap rises with the pace of economic growth.

Immigration is also a false elixir. That's because today's typical immigrant, who arrives with little money or marketable skills, costs slightly more in terms of public benefits like schooling and welfare than he or she generates in taxes. The only way immigration

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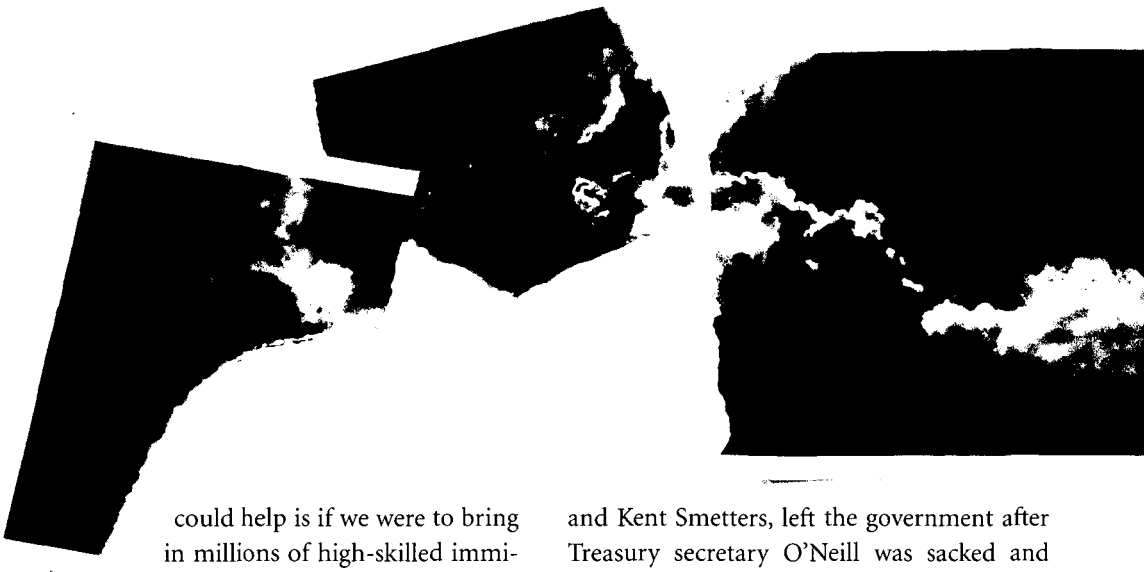
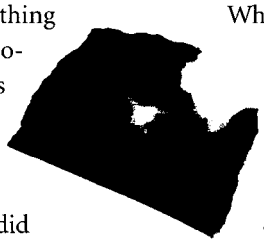


could help is if we were to bring in millions of high-skilled immigrants in their mid-40s and persuade them to leave before they started to collect Social Security and Medicare benefits. Since most high-skilled workers outside the United States are in Europe and Japan, and since these regions will be doing everything they can to retain these workers, the notion of using immigrants to shelter us from the coming generational storm is just wishful thinking.

Well, OK. But is it possible the $51 trillion figure is wrong? Where did this figure come from anyway?

Actually, from a reliable source. The estimates of the fiscal gap as well as the different ways to eliminate it were calculated by our very own government – specifically the U.S. Treasury. In 2002, Treasury Secretary Paul H. O'Neill commissioned a study of our long-term fiscal finances. The study, which was slated to appear in last year's White House budget, never saw the light of day. O'Neill was ignominiously fired in December 2002, and within a couple of days, the study was deep-sixed.

But truth will out. The two economists who wrote the analysis, Jagadeesh Gokhale and Kent Smetters, left the government after Treasury secretary O'Neill was sacked and published the analysis last spring under their own names. The study, *Fiscal and Generational Imbalances – New Budget Measures for New Fiscal Priorities*, was released as an American Enterprise Institute book.



When the study was released, *The Financial Times* got wind of its Treasury origins and reported both the findings and the fact of its censorship. But the press coverage died overnight when the White House denied in the strongest possible terms any relationship between the study and the Treasury. This was a remarkably bald lie, given the number of people inside and outside of government who had worked on the Treasury study or knew of it. Indeed, in Ron Suskind's book, *The Price of Loyalty*, Paul O'Neill himself confirms that the study released by Gokhale and Smetters, was in fact, produced at his behest.

The administration's discomfort with the truth about our long-term finances is understandable. After all, how could it hope to enact its third big tax cut, sharply increase discretionary spending, rebuild Iraq and pile

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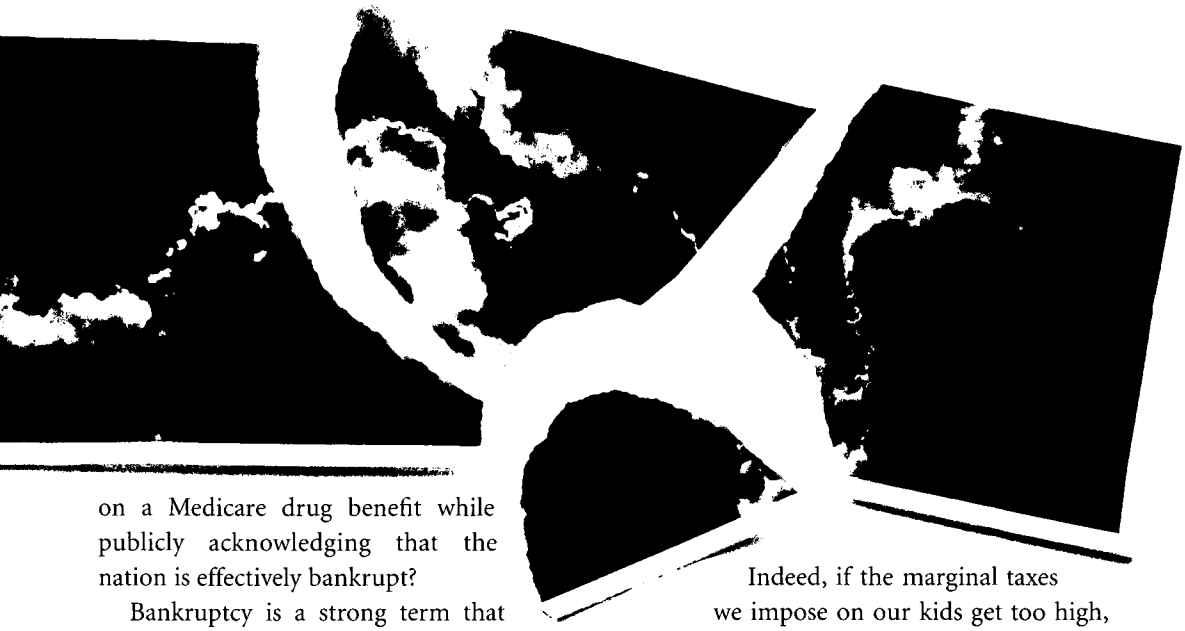


on a Medicare drug benefit while publicly acknowledging that the nation is effectively bankrupt?

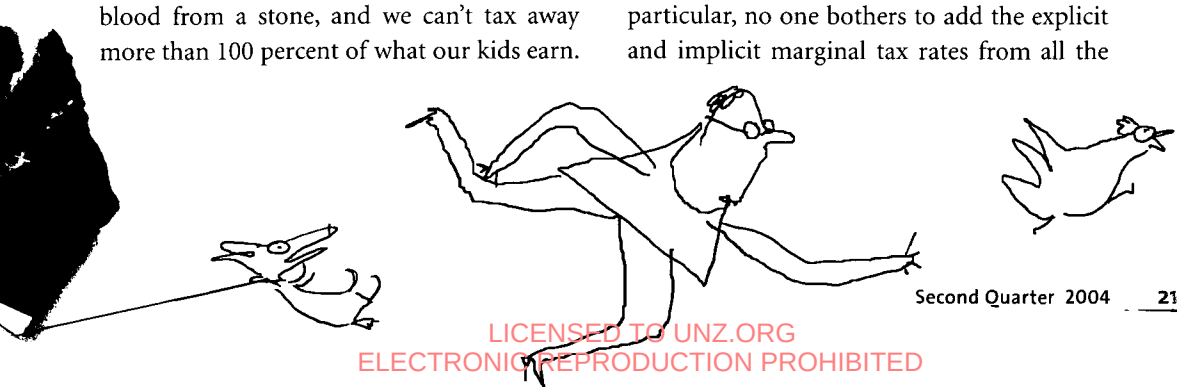
Bankruptcy is a strong term that shouldn't be used lightly. But in this case, it's the only term that fits. That's because none of the methods of eliminating the fiscal gap mentioned above, and no combination of these methods, have any realistic chance of being adopted by this or any other administration in the near future. And like failing to pay credit card bills, ignoring the fiscal gap makes things worse because the gap grows with interest. For example, waiting five years to raise federal income tax rates would leave us with a fiscal gap of $59 trillion and require, starting at that point, an 84 percent across-the-board tax increase to eliminate, rather than today's mere 78 percent tax increase. Thus, the longer we wait, the bigger the bullet someone will have to bite.

"Someone" appears to be today's and tomorrow's kids. But there's one hitch. Dumping the whole problem in their laps would leave the next generation facing lifetime net tax rates that are twice as high as those we adults now face. Unfortunately, we can't get blood from a stone, and we can't tax away more than 100 percent of what our kids earn. Indeed, if the marginal taxes we impose on our kids get too high, they'll either stop working, engage in tax evasion – or turn their backs on the elderly.

BLOOD FROM THE STONES

Today, you'd be hard pressed to find any American household, rich, poor or middle class, in less than the 50 percent marginal tax bracket when you factor in all the explicit and implicit taxes they face. Explicit taxes include federal and state income taxes, Social Security taxes, federal excise taxes (like the telephone tax) and state sales taxes. Implicit taxes refer to the loss in earned-income tax credit benefits, food stamps, welfare benefits, Medicaid benefits, Supplemental Security Income, housing assistance and other transfer payments that households – particularly low-income households – lose when they earn more money.

How did total effective marginal tax rates get so high? In setting individual tax and transfer policies, nobody in government ever bothers to look at the sum of the parts. In particular, no one bothers to add the explicit and implicit marginal tax rates from all the



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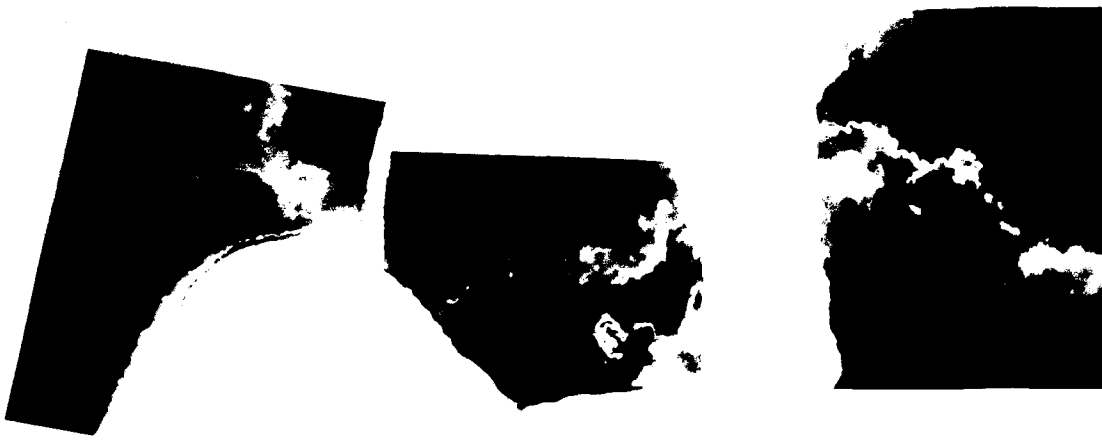


federal and state tax and transfer programs. Consequently, no one in government seems to understand that trying to double our kids' net lifetime average tax rates will mean such high marginal tax rates that Sweden will look like a tax haven.

Determining whether a company is bankrupt is always a judgment call. Even if current losses are large, there's always a chance that sales will pick up or that future cost-cutting can save the day. When it comes to the United States government's finances, there's also the possibility that things could go better than the Treasury Papers project. Unfortunately, the opposite is much more likely because the fiscal gap calculated in the Treasury Papers is based on a number of highly optimistic assumptions.

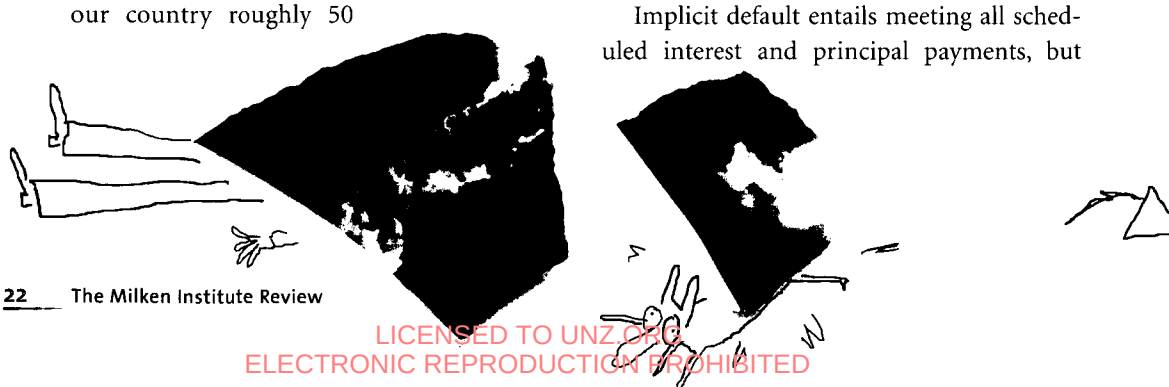
The two most important such assumptions involve the growth rate of medical expenditures and life span extension. According to the Treasury's projections, Medicare and Medicaid benefits per capita will grow only one percentage point faster than labor productivity. Historically, the differential has been 2.7 percentage points. Moreover, the Treasury Papers use Social Security's longevity projections, which assume that it will take our country roughly 50 years to achieve current Japanese life expectancy. Many of our nation's top demographers believe life span will increase far more rapidly.

In the private sector, it's up to creditors to decide when to pull the plug on companies or households that are going broke. They do so by refusing to lend them more money or by charging exorbitant rates of interest on loans. When countries go bankrupt, their creditors also pull the plug – and in much the same way. At some point the country decides that default makes more sense than continuing to service obligations that are fundamentally unaffordable.

THE B WORD

There is, however, one major difference between private and national default. Private default always has to be explicit, whereas national default can be explicit, implicit or a combination of both. Explicit default entails failing to make interest and principal payments. A good example here is Argentina, which simply declared on New Year's Eve in 2001 that it would no longer pay interest or principal on its $150 billion in outstanding government debt.

Implicit default entails meeting all scheduled interest and principal payments, but



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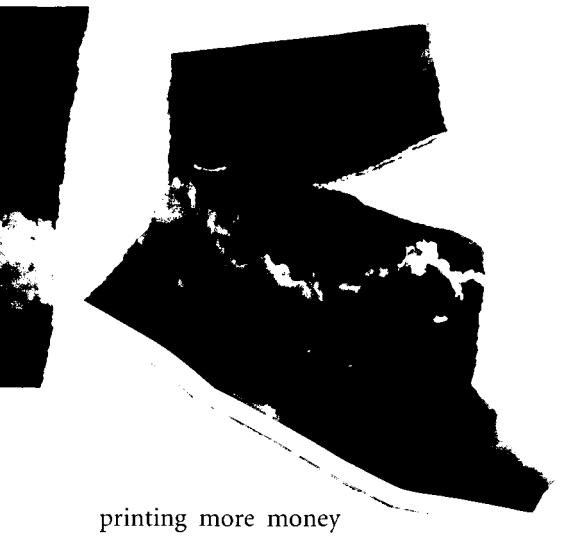
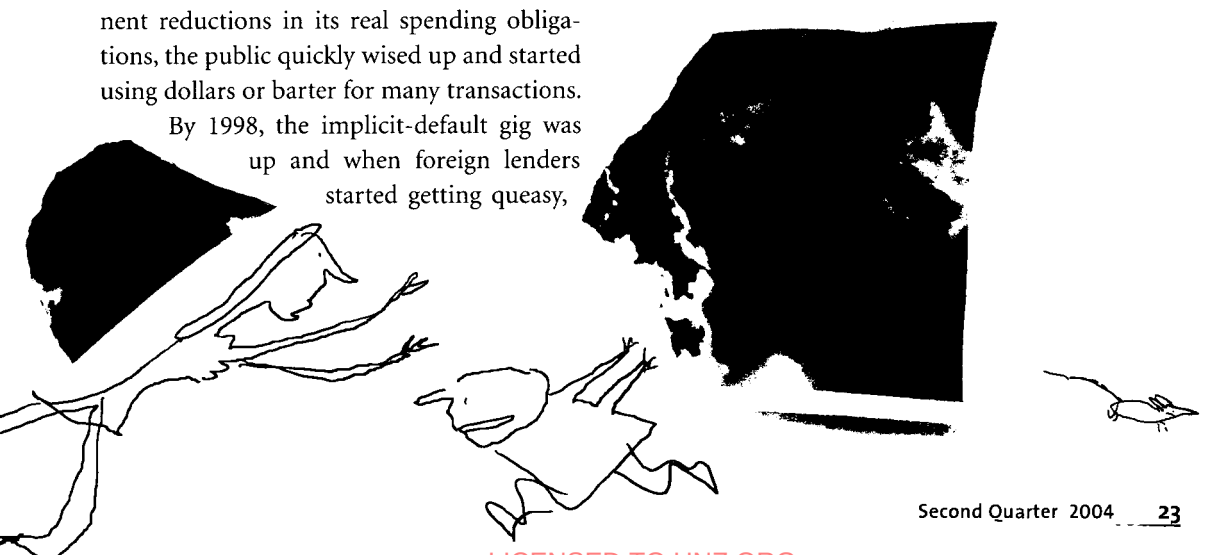


printing more money to cover the outlays. Russia in the mid-1990s provided a good illustration of implicit default. It printed rubles like crazy to cover bond obligations as well as to pay retirees their pensions, soldiers their salaries, etc. In doing so, the Russian government was able to claim it was fulfilling its commitments, when, in fact, it was making these payments in a currency whose purchasing power was rapidly shrinking. Today, many of Russia's elderly are living off state pensions worth only $50 a month.

Implicit default works to the extent the country's liabilities are denominated in local currency and not indexed to inflation. In Russia's case, much of its debt was denominated in dollars. And it was forced, over time, to adjust state pensions, military salaries and other expenditure obligations for inflation. While the country achieved some permanent reductions in its real spending obligations, the public quickly wised up and started using dollars or barter for many transactions. By 1998, the implicit-default gig was up and when foreign lenders started getting queasy, the government simply declared an official default on debt.

Brazil is the latest country to walk the default line. Most lenders to Brazil believe the country will default, explicitly or implicitly, on roughly $250 billion in official debt. Their only question is when. To compensate for the default risk, they are demanding interest rates of 18 percent before inflation and 10 percent after inflation. In contrast, United States nominal rates for similar short-maturity bonds are just 1 percent, and real rates are roughly -1 percent. In other words, Brazil's real "risk premium" – the extra interest the government pays to compensate lenders for the risk of default – is roughly 11 percentage points! Any country that has to borrow at real rates like this is in big trouble.

Mind you, Brazilian default is not guaranteed. Indeed, since September 2002, when the



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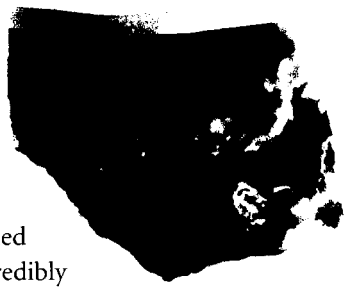

IMF lent Brazil $30 billion (the organization's largest loan ever), the county's real rates have declined by almost half to their current incredibly high levels. But a small amount of bad news or just increased skittishness on the part of lenders could send real rates even higher, making default inevitable.

Stated differently, default can become a self-fulfilling prophecy. All it takes is enough lenders to get more nervous about Brazil's prospects and real rates will soar, the Brazilian stock market will crash, the currency's exchange value will plummet, Brazilian banks will experience runs on their deposits, the Brazilian economy will tank and the government will throw up its hands and give the market what it expects – explicit default.

SUPERPOWER OR BANANA REPUBLIC?

For United States creditors, the question to ask is whether, in fiscal terms, the United States is Brazil or, indeed, whether it's actually in worse shape than Brazil. Brazil's explicit debt-to-GDP ratio is roughly 50 percent larger than that of the United States. And half of that debt is either denominated in dollars or explicitly indexed to inflation. This limits Brazil's ability to take advantage of inflation to welsh on its obligations.

On the other hand, Brazil is a much younger country in demographic terms. And though it, too, is aging, the elderly share of the Brazilian population is expected to remain at roughly half of the United States' share over most of this century. Hence, measured relative to its GDP, Brazil's implicit debt – the present value of its obligations to cover future state pensions, medical benefits and other transfer payments – may be much smaller than the United States' debt. I say "may" because no one has calculated Brazil's implicit debt or, for that matter, Brazil's fiscal gap.

In the United States, the fiscal gap is roughly 12 times the size of the official debt – that is, our nation's implicit debt absolutely swamps our explicit debt. Official debt may bear very little relationship to the size of the fiscal gap, which is the ultimate measure of whether a country risks going belly up. It also raises the possibility that Brazil's fiscal gap, scaled by Brazil's GDP, is smaller – indeed, much

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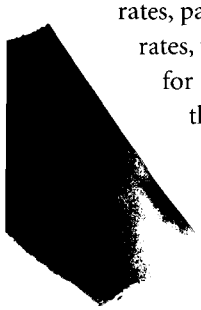
smaller – than the United States' fiscal gap, scaled by its GDP.

What would happen if bond traders were to wake up tomorrow and realize that they've been looking at the wrong measure of long-term fiscal solvency (official debt) and that when one looks at the correct measure (the fiscal gap), America's long-term fiscal position is horrible, and, potentially, much shakier than Brazil's? Presumably, they would dump U.S bonds, leading nominal interest rates, particularly long-term nominal interest rates, to soar. They would dump U.S. bonds for a good reason – the high likelihood that Washington would print tons of money to pay its bills and, therefore, implicitly default on its explicit debt by generating inflation.



If the Federal Reserve attempted to compensate by maintaining a tight monetary policy, these much-higher nominal interest rates would translate into much-higher real interest rates – which, in turn, would put the economy into deep recession. Hence, the Fed is likely to find itself playing a game of chicken with the bond market. If it delivers what the bond market expects – high inflation – it would limit the rise in real interest rates and allow the economy to continue to function. If it refused to increase the money supply and thereby kept inflation in check, the economy would go into recession and the added red ink would increase the size of the fiscal gap.

When will all this happen? Maybe tomorrow. It takes one straw to break the proverbial camel's back. The new Medicare drug bill – not to mention new estimates showing it will cost more than projected by the Congressional Budget Office – may be that straw. Or it may be the recent IMF report warning about United States fiscal insolvency. Or it may be the Congressional Budget Office's latest projection of a half-trillion-dollar official debt for the current fiscal year. Or it may be a stern warning from Alan Greenspan that we need to put our fiscal house in order.

Whatever it is that finally wakes up the bond market, once interest rates start to rise, the pressure will be on not only to print money but also to enact fundamental fiscal reforms. From that perspective, the sooner the bond market forces us to declare national bankruptcy, the better. ■

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The Mouse That's Roaring

How the Living-Wage Movement Is (Sort Of) Challenging the Conservative Consensus

By Jared Bernstein

A spectre is haunting America – the spectre of living wages. Many of the old powers have entered into a holy alliance to exorcise this spectre…

Well, Marx overstated the case, and perhaps I have, too. But the living-wage movement really is a mini-juggernaut. And in light of the anti-interventionist temper of our times, the success of so blunt an effort to nudge the invisible hand of the labor market deserves scrutiny.

First things first: what is the living-wage movement? Though organized efforts to raise wages are hardly new, the contemporary version appeared in the 1990s and is centered around a specific strategy: passing local ordinances to raise the wage floor for specified groups of workers to a level that more or less allows one income to support a family.

Living-wage provisions are now in effect in more than 100 cities, counties and other entities, like universities, and the pace of adoption seems to be accelerating. The Association of Community Organizations for Reform Now (Acorn), a living-wage advocacy group, reports that as of mid-2003 there were 72 living-wage campaigns in progress. If you

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live in an American city, chances are you've either got a living wage ordinance on the books for some workers, or a campaign to adopt one will be coming your way soon.

No two living-wage ordinances are the same; they differ particularly on the scope of workers covered. Many include the employees of city contractors – say, those providing mass transit or janitorial services. The next-largest group covers businesses that receive some type of subsidy under the rubric of economic development assistance, such as a tax abatement, a below-market loan, or the below-cost provision of city services or goods (e.g., as when a city agrees to pay for new infrastructure to attract a new factory or office building). Some living-wage laws cover both contractors and subsidized businesses.

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LIVING WAGE MOVEMENT

THE NUTS AND BOLTS

Ordinances can be quite specific about who is covered. Indeed, this issue of coverage is central to understanding the living-wage phenomenon. Acorn's Web site (http://livingwagecampaign.org/index.php) has detailed descriptions. Where I live, Alexandria, Va., the ordinance applies to all non-construction contracts in excess of $50,000. Firms that win such city contracts must pay their workers no less than $10.89 – more than twice the federal minimum wage. The Alexandria living wage was set at the poverty line for a family of four plus about $2 an hour, the average cost of health insurance. It is indexed to inflation.

In Los Angeles, non-supervisory workers employed by a service contractor are covered. Note, however, that workers providing *goods* under city contract are exempt. Thus, a security guard who works for a firm contracted to provide services to the city (e.g., cleaning or busing services) would be covered, while a guard who worked for a firm providing the city with goods (e.g., building supplies) would not. In Portland, Ore., occupational coverage is limited to janitors, security guards and parking attendants.

Indeed, in the give and take of political bargaining, exemptions – and sometimes expansions – can often find their way into the ordinances. In Boston, the original law covered service contracts with the city exceeding $100,000. But proponents later succeeded in lowering the threshold to $25,000. This ordinance is unique in that it formalizes activist involvement in enforcement through a "city assistance advisory committee," which includes one AFL-CIO member, one Acorn member and five mayoral appointees. In Chicago and many other cities, non-profits that contract with the city are exempted; in other cities, they are included, though there often exists a threshold in order to exempt smaller providers.

One relatively new target is universities. At Harvard, many students supported the successful campaign to cover security guards, custodians and dining service workers employed by the university directly or through subcontractors. The campaigners viewed outsourcing as the enemy. In this spirit, the agreement does not set permanent minimum wage levels, but includes a "wages and benefits parity policy" requiring that outsourced jobs provide wages and benefits comparable to those of in-house unionized workers performing the same work.

SMALL IS BEAUTIFUL, OR AT LEAST, POSSIBLE

Two key themes emerge here. First, coverage varies widely. Second, it is quite narrow. The wage levels may be high compared to state and federal minimums, but they do not reach many workers. No one knows just how many employees are affected – recordkeeping is poor and enforcement is spotty in some localities, and it's a moving target, anyway. My guess is that as many as 100,000 have had their wages boosted by the initiatives.

Given that one goal of the movement is, in Acorn's words, "to affect the ability of low-income families to live and work with dignity and respect," such diverse and often mar-

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ginal coverage seems hard to rationalize. Why should one employer or sector matter more than another? Why should workers under a small contract be exempt, while those performing the same tasks under large contracts be covered? Why cover workers on service contracts, but not those in manufacturing?

The answer, of course, is that politics is the art of the possible. In the hurly-burly of local activism, flexibility is rewarded by city councils and business interests. This flexibility avoids the one-size-fits-all model of, for example, the federal minimum wage, where regional differences in market wages are not taken into account.

Consider the case of San Jose, where the living wage is high compared to other ordinances around the nation. Community organizers there pushed for a big number because housing costs were so high in Silicon Valley and many nonprofessional workers had to travel long distances to get to work. In other cases, workers in certain occupations, such as those who toil in the school system (as in Milwaukee) might be seen as particularly deserving by influential parties, and thus might be strategically highlighted in the campaign and ultimately in the ordinance.

ORIGINS OF A MOVEMENT

Why are these ordinances sweeping the land? The movement was unsurprisingly driven by the increasingly difficult economic circumstances facing low-income working families in the past few decades. This, in turn, was largely the result of the disappearance of high-paying jobs for workers who didn't go to college. Between the early 1980s and the mid-1990s, hourly wages of low-skilled workers fell 18 percent in real terms.

The tight labor market of the late-1990s reversed this trend, and the minimum wage increase in 1996 helped, too. But even so, wage levels for most low-end jobs remain well below the levels needed to meet the basic needs of a family with children. What's more, history seems to be repeating itself: the persistence of weak labor markets during the

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current recovery has once again led to declines in real wages for the least-skilled workers.

Another factor driving the movement has been the privatization of services formerly provided by the public sector. A late-1990s survey found that more than half of state governments had increased the number of functions performed under private contracts over the prior five years, and that trend has surely accelerated since. Another study in Illinois, found that almost every municipality contracted out at least one service, and more than half outsourced at least 10. In the vast majority of cases, compensation was significantly lower in the private sector.

Living-wage advocates are also motivated by the proliferation of economic development incentives – tax breaks, subsidized loans and the like – handed out to attract business from other localities, or simply to keep the ones communities already have. "Private businesses that benefit from public money" should, in Acorn's words, "pay their workers a living wage."

Much living-wage-advocacy literature either implicitly or explicitly claims that both contractors and subsidy recipients are receiving some degree of "economic rents" from the city – i.e., profits in excess of the return needed to keep them doing business with, or deciding to locate in, the city. The ordinances are rationalized as a way to reclaim some portion of those rents and redistribute them among low-wage workers. And there's more here than rhetoric. If the higher wages are, in fact, paid out of redistributed rents, we wouldn't expect the impact of living-wage laws to conform to the usual gloomy predictions regarding minimum wage mandates, like job losses and higher costs for goods and services produced with premium-priced labor.

Those who actively oppose living-wage movements generally represent two related camps: affected employers (writ broadly to

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include contractors and subsidy recipients) and some members of local government (e.g., city councilors) and their clients: taxpayers, as well as residents who stand to lose services if their costs rise.

Private employers typically argue (in so many words) that they are currently paying what the market will bear, as determined by the marginal product of their work force. A mandated increase in wages, they argue, would compel them to pay above the market wage, forcing them to cut employment or to leave the market. Leaving the market, in this case, means either not bidding for contracts or relocating to a city without a living-wage ordinance.

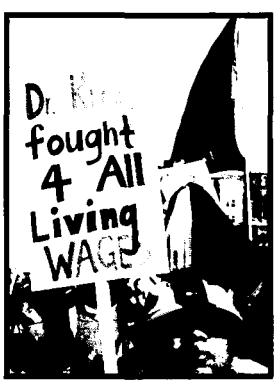
City officials who oppose living-wage laws typically do so because they believe that higher wages would both hurt the city's ability to compete for jobs and increase the cost of contracts, and thus force them to raise taxes or reduce services. In Utah, these opposing interests were so powerful that they passed a law prohibiting any locality within the state from adopting a living-wage ordinance.

WHAT THE NUMBERS SHOW

The evidence largely favors proponents. The few serious studies on the subject fail to find effects that would deter an objective policymaker from supporting living wages, at least in their current incarnation. For those still wedded to the Econ 101 prediction – mandate a wage hike and everybody working between the old and new wage loses their job – this may be hard to accept. But much of the contemporary empirical research on mandated wage floors suggests that modest wage increases with broad coverage (as in minimum-wage increases) and immodest increases with very limited coverage (living wages) can be absorbed without significant displacement of workers.

The evidence on living wages largely fits into three categories: the work of David Neumark of the Public Policy Institute of California, who has made a cottage industry of studying living wages (often with co-author Scott Adams); the quasi-experimental, before-and-after studies of localities that have adopted living wages; and various reports from city agencies responsible for oversight of the laws.

Neumark's papers are the most rigorous in technical terms, but, in my view, the least convincing. He uses a national database with tens of thousands of observations. But for all the information at his disposal, he can identify neither firms nor workers directly affected by ordinances. His data only allow him to know which cities workers live in (not even the city they work in), and from this, he has to parse out a statistical signal from a policy that reaches far less than 1 percent of the labor force.



Given the data limitations, you would expect that he would come up with very little. Instead, he finds large effects on wages (compared to the broader literature) and incomes, as well as on employment. The employment effects are negative, but not large enough to offset the impact of wage gains on total wages paid. And he argues these effects go well beyond the small group covered by the ordinances, affecting the whole bottom-tenth of the city's wage scale.

For these findings to be on the mark, it would have to be the case that by raising the wages of a select few workers in a handful of occupations, many more firms would be

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forced to raise wages for many more workers in order to obtain the labor they need. He might be right, but skeptics abound.

Two before-and-after studies of living wage ordinances – one for Boston, the other for Los Angeles – reinforce that skepticism. Mark Brenner, an economist at the University of Massachusetts' Political Economy Research Institute, used original survey research to compare low-wage and higher-wage firms affected by the Boston ordinance. Since the latter didn't have to raise wages to meet the ordinance, the comparison amounts to a natural experiment.

Employment increased after passage for both types of firms, though the increase was slightly greater – but not statistically significantly so – among those that did not need to raise wages. Interestingly, the increase in the number of full-time workers was the same for both groups; the firms that raised wages substituted full-time for part-time labor. Brenner's study also finds a significant wage-compression effect, as the ordinance essentially forced low-wage contractors to truncate the bottom tail of their wage distribution.

The Los Angeles study, by David Fairris of the University of California (Riverside), finds a very large wage effect from the mandate, as affected workers average a 24 percent pay increase compared to a control group. Though he lacked the data to do a controlled employment comparison, he was able to examine a set of what he calls "indirect effects of the living wage" – differences in turnover, absenteeism, training and overtime between affected and unaffected firms. These measures are potentially helpful in understanding how firms absorb the increase in labor costs resulting from the wage mandate. Living-wage advocates argue that "efficiency-wage effects" – the greater productivity sometimes achieved by firms that pay above-market wages – allow much of the wage increase to be absorbed by employers.

In this vein, Fairris finds large turnover-reduction effects, and smaller reductions in absenteeism.

One negative finding is that the living wage reduced the provision of job training, compared to non-living-wage firms. Fairris argues that this result may support the notion that "wage mandates such as living wages prevent workers from striking a deal with employers that reduces wages temporarily in exchange for job training."

The last category of relevant research consists of administrative reports from those who monitor and implement the laws. These are not academic studies with control groups, but they do offer two invaluable pieces of information: hard counts of the number of workers with wage increases, and qualitative information on the impact on city budgets.

On the question of budget impact, one living-wage researcher, Andrew Elmore of New York University Law School's Brennan Center, reviewed the city reports and found what he called "modest contract price increases for a small proportion of contracts," leading to overall increases in contract costs to the city that were usually less than 1 percent. Elmore does, however, note a few larger increases in individual contracts linked to the ordinances, including a 31 percent increase in a security contract in Hartford (the only contract covered there), a 22 percent increase in a janitorial contract in Warren, Mich., and increases of 10 percent in about 5 percent of the city contracts in Berkeley, Calif.

The fact that the ordinances do not appear to increase city budgets much is largely a function of the very limited coverage. Reports that give the numbers of directly affected workers show:

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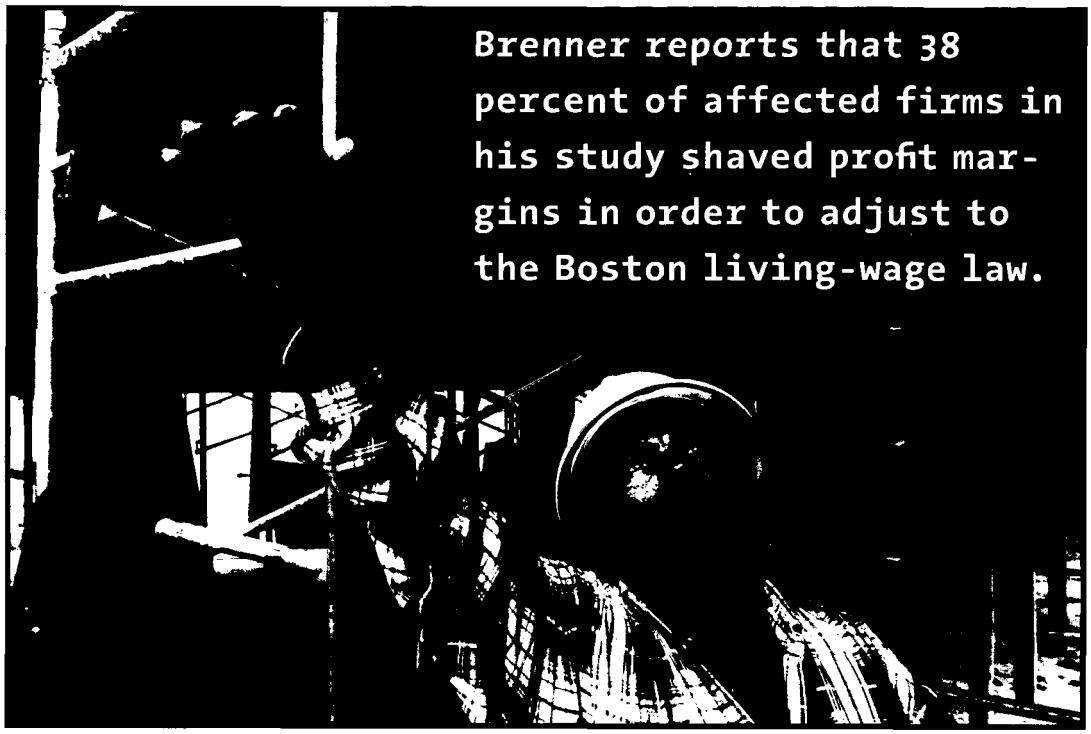
Brenner reports that 38 percent of affected firms in his study shaved profit margins in order to adjust to the Boston living-wage law.

- 41 workers in Corvallis, Ore.
- 54 workers in Hartford, Conn.
- 54 workers in Hayward, Calif.
- 338 workers in Minneapolis, Minn.
- 106 workers in Pasadena, Calif.
- 55 workers in San Jose, Calif.
- 75 workers in Ventura County, Calif.

The fact that related budget increases are small compared to the total budgets of the localities does not, of course, imply that they are trivial or non-problematic. But the city studies do suggest that most contractors do absorb the cost increases.

A Pasadena administrator reported that the city "negotiated with contractors for a substantial absorption of contract costs," which turned out to amount to about half of the increased labor costs. A supervisor in Ypsilanti, Mich., found that the cost of the town ordinance was held down by an increase in the numbers of bidders. Her explanation was that "now that the wage standard is equal, the ability to compete is based on factors other than wages, so you've got to be tighter and provide less of a profit margin" – a view that gives some support to the redistribution-of-rents argument made by living-wage advocates. Brenner also reports that 38 percent of affected firms in his study shaved profit margins in order to adjust to the Boston living-wage law.

Still, there is one negative finding here that caught my eye. The city of Oakland has a subsidy-based living-wage ordinance, and Elmore reports that two national retailers abandoned projects there, in part due to the ordinance. While "a living wage law may deter retailers from pursuing economic subsidies," he concludes that "attracting national retailers through a subsidy program may not be a wise public policy approach." Yet one can easily imagine cases in which a locality – say, one with very weak employment growth – would benefit considerably from attracting retailers. At any rate, living-wage advocates need to be mindful of this potential cost when they

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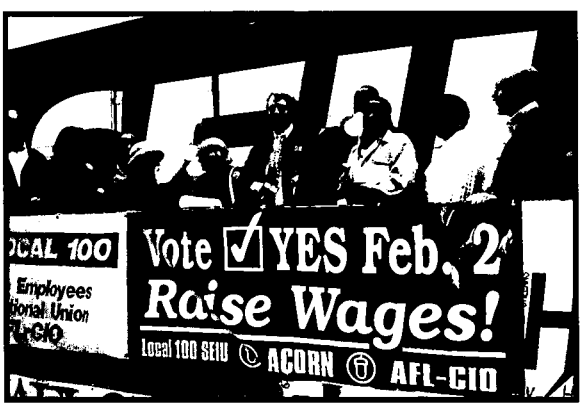
attach the wage mandate to employers who benefit from local government subsidies.

THE WHOLE IS GREATER

While a central goal of the living-wage movement is to raise the living standards of low-income working families, there is more to it than that. Advocates also want to build durable coalitions to promote social and economic justice, to hold local government accountable,



and to raise the profile of other labor-market intermediaries – mainly unions.

We know more about the living wage's impact on living standards. Critics argue that living wages cannot help much since (a) they are poorly targeted because they often flow to low-wage workers in middle-income families, (b) they hurt their intended beneficiaries because they lead employers to replace the least-skilled workers with higher-skilled ones, and (c) their benefit is diminished by the loss of government entitlements that fall as earnings rise.

Targeting doesn't appear to be much of a problem, since most beneficiaries earn incomes in the bottom-half of the income scale. It is probably the case that relatively few are working poor by the government's definition of poverty, but this is a very restrictive benchmark. For those who believe that lower-middle-income families should benefit from the policy, targeting should not be a major concern. Similarly, no one has shown that living wages displace the least-skilled. Robert Pollin of the University of Massachusetts' Political Economy Research Institute finds that there is not much of a skills gradient in the low-wage sector, anyway. That is, the workers who demand $10-an-hour to be coaxed into what had been a $6 job aren't much more skilled than those who will work for $6. The bottom line: implement a living wage, and you will most likely improve the earnings of a small group of nearly-poor who didn't go to college.

There is some evidence, however, to support the third critique above: some of the wage gains are offset by a loss of safety-net benefits keyed to low-wage workers. That is, you might gain a bit more in wages and lose a bit more in food stamps.

But all of these critiques miss the main point: living-wage ordinances face a paradox. Because the ordinances are limited in their coverage, their advocates have been able to convince city officials – and by proxy, taxpayers – that they will accomplish their stated goals without leading to significant layoffs, tax hikes or reduced competition for contracts. And the evidence presented here broadly supports this claim.

But the marginal coverage of the policy limits its impact to raising the living standards of a tiny fraction of America's working poor and near-poor – I guessed just 100,000. In a low-wage labor market of roughly 25 million, this gives a sense of the limitations of the movement.

WIDENING THE NET

Could living-wage movements reach more people? There are two interesting develop-

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ments afoot worth considering in this regard. The first is city-wide minimum wages. Some living-wage advocates view this as a sure-fire way to solve the low-coverage constraint. With help from Acorn and others, New Orleans passed a city minimum. But implementation was prohibited by the state's supreme court, based on jurisdictional issues. At this point, only Santa Fe, N.M., has a city minimum, a floor of $8.50 that applies to any establishment with at least 25 employees. Washington, D.C. has had a higher minimum wage than the federal one for a decade, but that's a special case. There's also an active campaign in Madison, Wisc., for a city-wide minimum of $7.75.

In a better world, with a reasonable federal wage floor, cities (and states) would not have to take matters into their own hands. But Washington is about to tie the Reagan record for ignoring the minimum wage (nine years), which isn't indexed to inflation and is thus not much of a wage floor in many areas of the country. The city-wide minimum wage is a very different beast, of course, with different implications than the federal policy, where all firms in the nation face the same regulation. Even veteran supporters of moderate minimum-wage increases worry that minimums affecting individual local labor markets could have significant employment effects.

But take it from one of those veterans: assuming a moderate increase that doesn't catch more than about 10 percent of the work force in its net, you just cannot know the impact until you try it. There are simply too many exceptions to the rules according to Adam Smith to be sure.

Another interesting development is a hybrid policy mixing the living wage with a local earned income tax credit (EITC) mirroring the federal one. The EITC is a substantial (and popular) federal wage subsidy for low-income families. Opponents of living wages endlessly raise the EITC as a preferred alternative. But, while the EITC is a fine program, it is difficult to see why the existence of the EITC would, or should, deter any policymaker from considering the living wage. Clearly, the wage mandate is about adding to the incomes of low-income working families, and the fact that a generous and well-targeted federal tax credit exists is not particularly relevant. Living-wage advocates argue that the two policies are thus complements, not competitors.

In two communities, however, advocates for low-income working families have succeeded in passing both a living wage and a local EITC – that is, a locally funded add-on to the federal credit. In Montgomery County, Md., federal EITC recipients can receive an extra 16 percent of the family's federal credit. Denver also has both a living wage and a local EITC. This keeps a local emphasis, improves coverage and targeting, and splits the cost between local taxpayers (EITC) and business (living wages).

At any rate, there is a lot to be said for the living-wage movement thus far. It has been extremely successful in a climate not particularly conducive to market intervention. Again, limited coverage surely plays a role here, as city councils are more willing to take risks with small programs than large ones. But it is also generating some badly needed grass-roots organization in favor of socioeconomic justice.

That said, the living wage movement is still a mouse with a good set of vocal cords. It has captured the attention of low-wage organizers, the media, academics and nonprofit foundations in an era in which the sensible left has largely been demoralized. Yet its reach is inherently constrained. Whether the mouse morphs into a lion is yet to be seen. ◼

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Religion AND Economic Growth

By Robert J. Barro and Rachel M. McCleary

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Does organized religion that demands the expenditure of considerable time and resources on the part of the devout undermine economic productivity?

In an era in which the richest countries (with the major exception of the United States) have relegated religion to secondary roles and some of the poorest seem consumed by fundamentalist visions, it should not be surprising that religion is often viewed as detrimental to economic development. Indeed, it is hardly a new idea: the Protestant ethic, with its emphasis on hard work, saving and the secularization of society, was celebrated by Max Weber as a critical factor in the rise of capitalist Europe. But strikingly, the relationship between religion and the determinants of economic growth in the modern world have not been examined in a rigorous way.

Here, we attempt to fill the gap, using statistical analysis across countries. The most useful sources of international data on church attendance and religious beliefs are the three waves of the non-profit World Values Survey (1981 to 1984, mostly 1981; 1990 to 1993, mostly 1990; and 1995 to 1997, mostly 1995 and 1996); the two reports on religion by the non-profit International Social Survey Programme (1990 to 1993, mostly 1991; and 1998 to 2000, mostly 1998); and the for-profit Gallup International Millennium Survey (1999).

Putting the various sources of religion data together, and considering the availability of data on other variables, we were able to carry out statistical analysis designed to isolate the determinants of economic growth for up to

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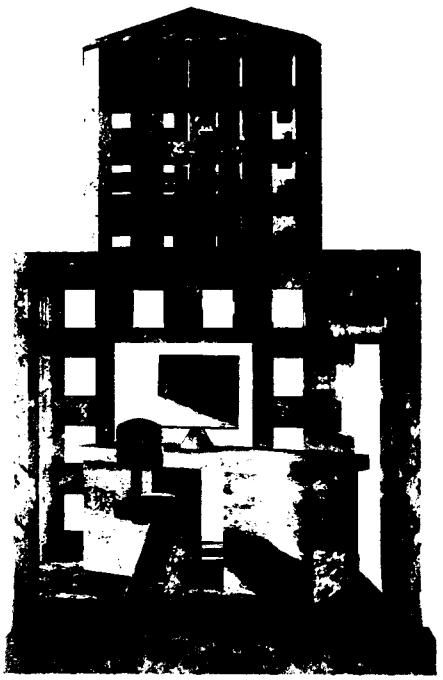

59 countries. These include up to 23 countries observed around 1981, 37 around 1990, 22 around 1991, 32 around 1995, 28 around 1998, and 41 around 1999. The exact sample size for the regression analyses depends on the measure of religiosity.

The countries covered tend to be richer and more Christian than the world as a whole. The only predominantly Muslim countries are Bangladesh, Malaysia, Pakistan and Turkey. Countries that have predominantly Eastern religions among people expressing some religious adherence are China, Hong Kong, Japan, South Korea, Singapore, Taiwan and Thailand. Some of these countries – notably, South Korea – have experienced large numbers of conversions to Christian sects over the last 30 years.

BELIEVING, BELONGING AND PRODUCING

Using statistical analysis to tease out the separate effects of factors on economic development, we found that economic growth responds positively to religious beliefs – notably to belief in the concepts of hell and heaven. But, by the same token, growth is negatively related to church (temple, mosque, etc.) attendance. Or to put it more succinctly, growth depends on the extent of "believing" relative to "belonging." These results are in accord with a model in which religious beliefs influence individual traits that enhance economic performance. And they contradict the secularization hypothesis, which, according to Weber, dates back at least to the ideas of John Wesley, the founder of Methodism in the late 18th century.

In Weber's view, economic development causes individuals to become less religious, as measured by both church attendance and religious beliefs. The beliefs may refer to God, an afterlife, heaven, hell and so forth, or just to tendencies of people to characterize themselves as religious. The secularization hypothesis also encompasses the idea that economic development causes organized religion to play a lesser role in political decision-making and, more generally, in social and legal processes.

Economic development typically features an array of changes, including increases in per capita income, education, life expectancy and urbanization, along with reductions in fertility and infant mortality, and changes in age structure. The predicted effect of development on religiosity depends on the particular aspect of development. Hence, it is important in theoretical and empirical treatments to distinguish among these aspects.

For example, education is one important correlate of development. One argument for the secularization hypothesis is that people with more schooling are more likely to believe in the scientific method and are, therefore, more inclined to reject doctrine that relies on supernatural forces. Put another way,

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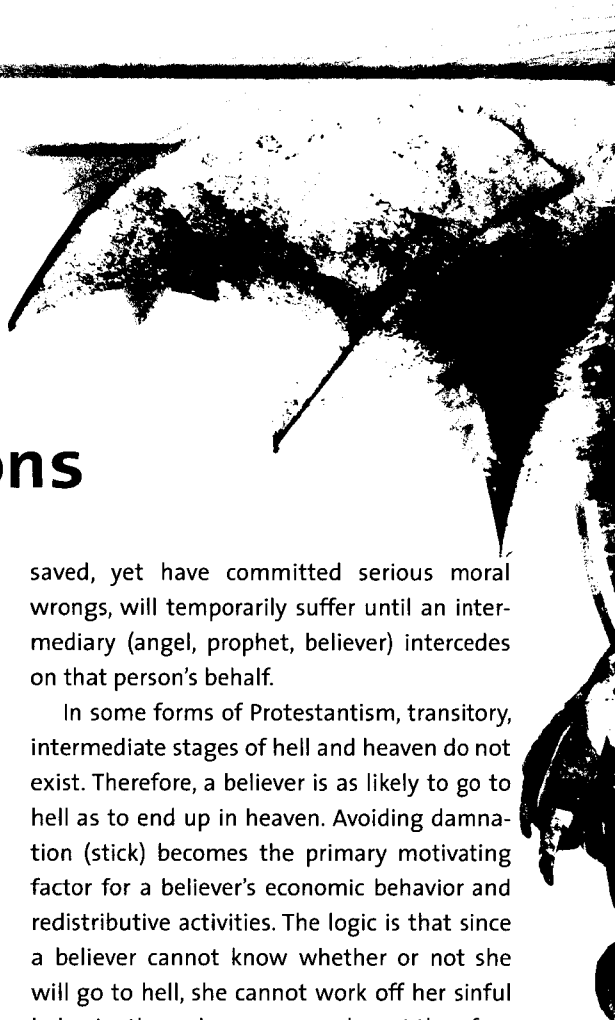

Heaven and Hell in the Major Religions

Beliefs in heaven and hell of the major world religions – Hinduism, Buddhism, Christianity and Islam – provide varying incentives for performing economic activities. Hinduism and Buddhism tend to emphasize positive incentives (carrots) for economic activities. In these religions, believers who perform their obligations are reincarnated into heavenly intermediate stages (carrots). Those who fail to perform their obligations are reincarnated into intermediate, transitory stages of purgatory (sticks). Supererogatory acts of merit help a person move into a higher stage of heaven by earning salvific merit, and can shorten a person's stay in purgatory. Reincarnations occur when the individual sheds bad karma in the temporary and intermediate stages of hell, and moves toward perfection, or *mokṣa*. In short, Hinduism is a belief system on how to attain perfection.

Islam and Roman Catholicism mix positive and negative incentives for economic behavior. Both religions interpret hell as having transitory levels, with an ultimate permanent hell. Heaven, like hell, is a permanent state. Those who end up in hell do so as a consequence of their own free will, and not as the result of a vengeful God. There are levels of hell, where individuals who may still be saved, yet have committed serious moral wrongs, will temporarily suffer until an intermediary (angel, prophet, believer) intercedes on that person's behalf.

In some forms of Protestantism, transitory, intermediate stages of hell and heaven do not exist. Therefore, a believer is as likely to go to hell as to end up in heaven. Avoiding damnation (stick) becomes the primary motivating factor for a believer's economic behavior and redistributive activities. The logic is that since a believer cannot know whether or not she will go to hell, she cannot work off her sinful behavior through penance, and must therefore work diligently in order to (a) contribute to her salvation, or (b) receive a sign from God that she has been saved.

Analyzing data from the three waves of the World Value Survey (1981; 1990 and 1991; and 1995 and 1996), Muslims are more likely than Catholics, Hindus, Buddhists and Protestants to profess a belief in heaven and hell. Given that Protestants tend to believe in the eternal nature of heaven and hell with no intermediate degrees, and that a believer has only this lifetime to earn salvation, it would seem that Protestants would express a higher belief than Muslims in the ends of the afterlife.

A possible explanation for the finding is

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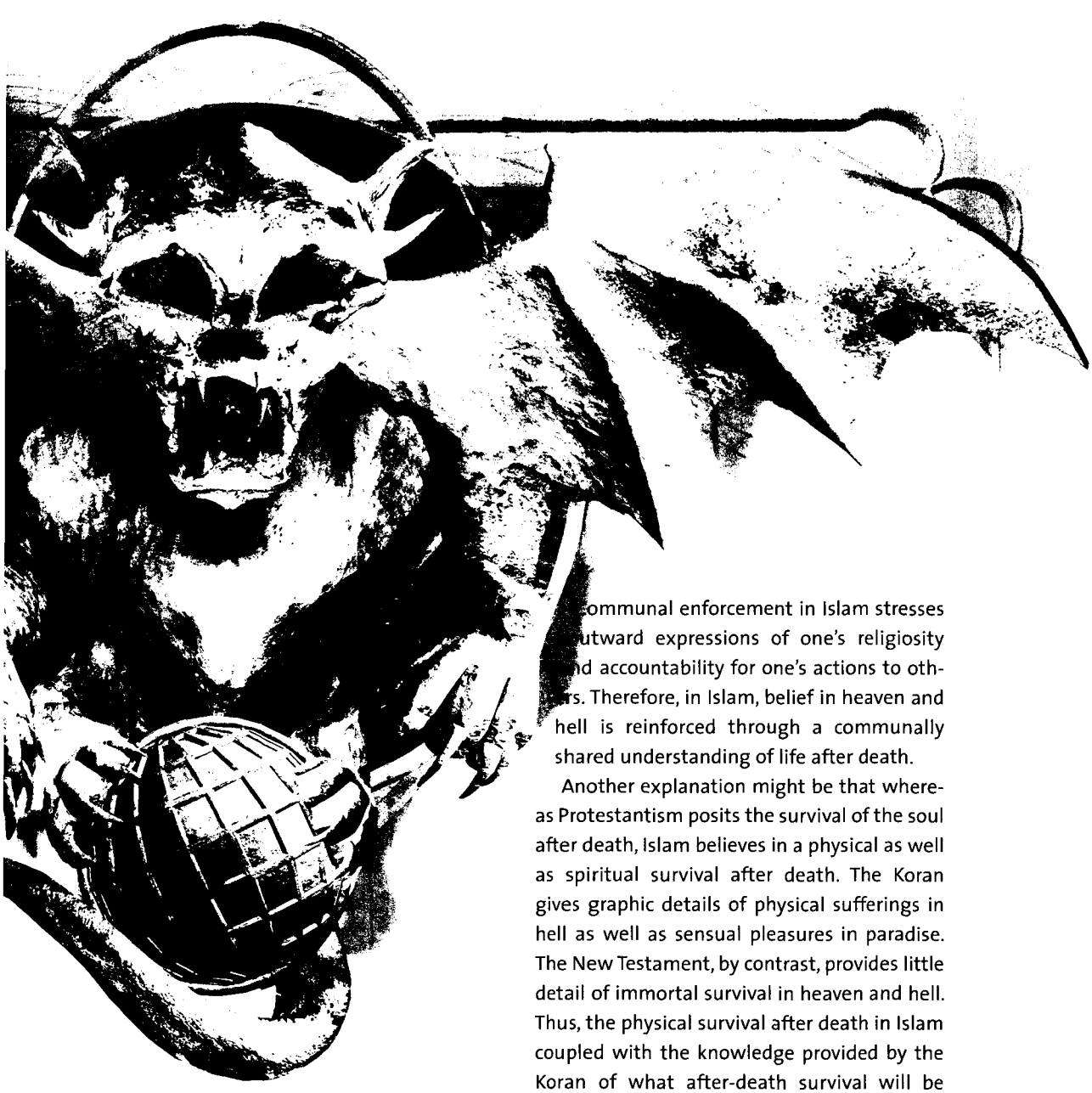

that whereas Christianity, particularly in the form of Protestantism, places emphasis on individual responsibility for one's religious obligations, Islam is legalistic, stressing the fulfillment of laws that are communally enforced. The laxness of communal enforcement of religious beliefs in Protestantism creates an individualist approach to religious living – a focus on the inward, personal relationship with God.

ommunal enforcement in Islam stresses utward expressions of one's religiosity nd accountability for one's actions to oth- rs. Therefore, in Islam, belief in heaven and hell is reinforced through a communally shared understanding of life after death.

Another explanation might be that whereas Protestantism posits the survival of the soul after death, Islam believes in a physical as well as spiritual survival after death. The Koran gives graphic details of physical sufferings in hell as well as sensual pleasures in paradise. The New Testament, by contrast, provides little detail of immortal survival in heaven and hell. Thus, the physical survival after death in Islam coupled with the knowledge provided by the Koran of what after-death survival will be like, makes heaven and hell quite real for the believer.

Yet a third explanation for why Muslims have a stronger belief in hell than Protestants is the epistemological uncertainty that gives rise to what Max Weber called "religious anxiety" leading to increased productivity or industriousness. Hence the Protestant lack of assurance in salvation leads to greater productivity – not a stronger belief in hell.

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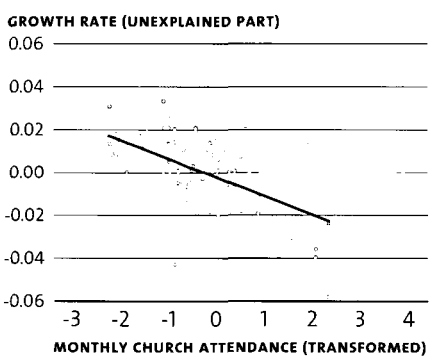
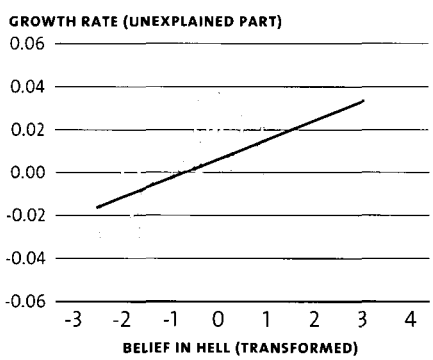
Statistical Results on Religion and Economic Growth

The figures illustrate the effects on the rate of economic growth from monthly church attendance and belief in hell. These results come from cross-country evidence from the 1960s through the 1990s. The graphs are constructed to hold constant the influence on economic growth from an array of explanatory variables other than the one shown on the x-axis. Specifically, Figure 1 shows the negative effect of monthly church attendance on economic growth while holding constant the belief in hell, whereas Figure 2 shows the positive effect of belief in hell on economic growth while holding fixed monthly church attendance. Thus, the graphs represent the effect on economic growth not from an overall change in religiosity but, rather, from a shift in belonging with believing held fixed, or vice versa.





if religious beliefs are based primarily on ignorance, more-educated people would tend to be less religious. That viewpoint was expressed by the Scottish philosopher David Hume and as well as by Sigmund Freud, who argued that religion derived from irrational human fears and anxieties.

A contrary argument is that religious beliefs, like many theoretical hypotheses, require abstract thinking, or "faith." If educated people are more capable of the abstractions needed for intellectual inquiry, they may also be more able and willing to make the abstractions needed to support religious beliefs. Therefore, from this perspective, educated people may be more religious.

Bruce Sacerdote and Edward Glaeser of Harvard provide yet another explanation for why increased education would spur church attendance. They argue that education increases the returns from social networks and other forms of social capital.

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Hence, they predict that more-educated people would have stronger incentives to participate in group activities, including church services. This argument reinforces Robert Putnam's view of the importance of social capital, found in his widely read book, *Bowling Alone: The Collapse and Revival of American Community.*

However, in the Glaeser-Sacerdote-Putnam approach, church attendance bears no special relation to religious beliefs – churchgoing is modeled as just one of many ways to build social capital. Hence, this analysis predicts no clear relationship between education and religious beliefs, except insofar as more frequent church attendance instills greater beliefs.

Models that focus on salvation predict that people will become more religious as they age and, hence, get closer to death. Similarly, for a given age, the prediction is that religiousness would be higher the lower one's life expectancy. Weber observed that Catholicism allowed for a continual cycle of sinning and absolution. Therefore, people have an incentive to accumulate sins early in life and then repent as they get closer to death. Weber argued that this pattern did not apply to Calvinist Protestantism, which dictated daily moral conduct throughout life as the only means of finding a sign that one had been chosen.

ECONOMIC GROWTH AND THE COSTS OF RELIGION

Economic reasoning implies that anything raising the cost of religious activities would, other things equal, reduce these activities. For example, economic development raises the value of time, as measured by market wage rates. Hence, development implies a rising opportunity cost of participating in time-intensive activities like church services and prayer. It would follow that development tends to reduce church attendance and other religious activities.

Seen from this perspective, children tend to go to church services relatively often because their costs of attendance are comparatively low. This effect is reinforced because the productivity of attendance – in the sense of the beliefs engendered through indoctrination – is likely to be high at young, formative ages. Moreover, the incentive to bring children to church tends to induce greater church attendance by adults, who are likely to want to participate in the process of inculcating their children. Therefore, the declining fertility rates that typically accompany economic development are another force that supports the trend toward secularization.

Economic reasoning implies that anything raising the cost of religious activities would, other things equal, reduce these activities.

Urbanization – another strong correlate of economic development – has also been seen as a substantial negative influence on religiosity. One reason is that church services have to compete with forms of leisure activities in urban areas, like museums, theaters and political organizations.

The sociologists Bryan Wilson and Peter Berger built on a theme from Weber, arguing that economic development leads to the secularization not only of individuals but also of political and social institutions, including the churches themselves. Notably, official state

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churches would become less common. And separation of church and state would become more pronounced, with organized religion exercising a diminishing influence over social and economic regulation involving matters like markets, marriage, divorce, birth control, abortion and euthanasia. Church services would also become less demanding – for example, churches would abandon the use of foreign languages, require smaller outlays of time by participants, simplify elaborate rituals and require less stringent devotional practices by adherents.

Beginning in the 1970s, a wide variety of studies conducted by anthropologists, including Richard F. Gombrich, Ronald P. Dore and Gananath Obeyesekere, offered a different perspective. They found that secularization was not always the result of economic development and modernization. Rather, conversely, the rise of new religious movements and the rapid spread of religions could be attributed to the disparity between the promises of industrialization and the reality of low-income countries that had yet to deliver prosperity. Hence, this argument stresses not the level of economic development, but rather the frustrations related to inequality of income and to unfulfilled expectations of rising income.

Another argument by secularization theorists is that religiosity is fostered by the existence of a monopoly provider of religion – for example, by an established state church. If competition exists among churches, in part it takes the form of debunking the religious beliefs practiced by others. If the beliefs are based primarily on superstition and ignorance, the argument is that these beliefs cannot withstand the competition. Hence, according to this view, the demise of official state churches – predicted to be a part of the secularization process – would foster the decline in individual church attendance and beliefs. Some of this idea is reflected in Adam Smith's *Inquiry into the Nature and Causes of the Wealth of Nations*, and is attributed partly to David Hume.

Religion, Smith argued, is thus more vibrant where there is a disassociation between church and state, because the absence of state religion creates a climate for competition among religion providers.

There is a countervailing force at work here, though. Smith also noted that monopoly providers of religious services tend – as monopolies do generally – to become non-innovative and indolent. He particularly observed this behavior in the Church of England, where religious "zeal" was frowned upon. Religion, Smith argued, is thus more vibrant where there is a disassociation between church and state, because the absence of state religion creates a climate for competition among religion providers.

The Smithian perspective on religious competition has been used by two sociologists, Rodney Stark and William S. Bainbridge, to develop a "market" or "supply-side" model of religious participation. Their argument is

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that greater religious pluralism – measured, for example, by an index of the diversity of religions that exist in a country or region – tends to promote better service and, hence, encourages religious participation. Moreover, an established state church tends to deter religious pluralism and, hence, to lead to "bad" service and low participation in organized religion.

Note, however, that the connection between pluralism and religious beliefs would be expected to be weaker than that between pluralism and church attendance. That is, individuals may sustain a high degree of religious beliefs even if they rely little on the support from organized religion.

WHY RELIGION MATTERS

We find a strong relationship between economic growth and religiosity. In our analysis, we simultaneously include measures of church attendance and religious belief. To put it another way, the main impact of religion on growth is a positive response to an increase in believing *relative* to belonging (attending). It should thus not be surprising that striking patterns of relatively high beliefs and low church attendance appear in some Scandinavian countries and in Japan.

Governments can also suppress religion – either specific ones or religion in general. For example, the Soviet Union and China tried hard to eradicate organized religion both because religion figured prominently in Marxist theory and, more practically, because it was regarded as competition to the Communist quasi-religion. From an empirical perspective, it is interesting to examine not only the impact of Communism on church attendance and religious beliefs, but also the changes that occurred since the elimination of Communism in many countries in the 1990s.

Our statistical results show that, for given religious beliefs, increases in church attendance tend to reduce economic growth. In contrast, for a given level of church attendance, increases in core religious beliefs – notably in hell, heaven and an afterlife – tend to increase economic growth. There is some indication that the stick represented by the fear of damnation is more potent for growth than the carrot from the prospect of salvation.

We conjecture that religious beliefs stimulate growth because they help to sustain aspects of individual behavior – honesty, thrift and work ethic – that enhance productivity. Note that our statistical estimates do not imply that greater church attendance has a net negative influence on economic growth. Rather, the net effect depends on the extent to which an increase in attendance leads to stronger beliefs.

Having many religious holidays or requiring congregants to attend services does not necessarily translate into more believers. Furthermore, joining a church for social reasons (the Glaeser-Sacerdote-Putnam social capital approach) may not produce the kind of beliefs that lead to personal traits that enhance productivity.

Contrary to the social capital argument, we find that, for given levels of religious beliefs, the effect of greater church attendance is to reduce economic growth. This effect combines the negative effect of the resources used up by the religion sector, the positive networking effects of religious congregations and the ambiguous influence of organized religion on laws and regulations.

If the goal is to put religion to the service of economic development, perhaps the solution is to have children attend religious classes while their parents go off to work. Religion, it seems, is for the young, when the opportunity cost of their time is low and their capacity for absorbing pro-growth values is high. ■

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The Game

The Decline of Social and Economic Problems in America

By John F. McDonald

Yes, the decade of supercharged economic growth and vanishing unemployment seems a distant dream. Yes, terrorists are plotting the destruction of Pax Americana. Yes, millions live with the uncertainty of AIDS. Yes, the cultural divide between the red and blue states seems wider than ever. But, believe it or not, many of the social and economic challenges that seemed so formidable a few decades ago are becoming more manageable. And – dare I say it – the liberal dream of progress in America is alive and well.

HEALTH

Start with the basics. Life expectancy at birth has increased for all socioeconomic groups in America. The largest gain has been enjoyed by African-American men, who could expect to live to age 60 in 1970, yet by 2000 had a life expectancy of 68.2 years. Indeed, black men's expected lifespan increased by a remarkable 3.7 years in the 1990s alone.

Life expectancy for black women also improved, rising from 68.3 years in 1970 to 74.9 years in 2000. Whites didn't do quite as well, with men's life expectancy rising 6.8 years and women's rising 4.4 years, to 74.8 years and 80 years respectively. But the narrowing of the statistical gap between whites and blacks is good news in itself, suggesting that the consequences of poverty and racial discrimination are less glaring than in the past.

Age-adjusted death rates, which offer a related perspective on longevity, have dropped as well. The rate for white men declined by 33 percent and for black men by 27 percent from 1970 to 2000.

The causes of the increase in life expectancy and the decline in mortality are closely related to reductions in specific risk factors. Deaths from heart disease, still the largest cause of mortality, declined from 493 per 100,000 people in 1970 to 258 in 2000. Deaths from strokes dropped from 148 to 60 per

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100,000 over these same 30 years, a decline of 60 percent. The death rate from cancer did not change. However, ongoing efforts to reduce smoking among Americans may mean that a decline in the cancer rate is on the horizon. Meanwhile, the death rate from accidents dropped by almost half. And the age-adjusted death rate from AIDS went from a peak of 16.3 per 100,000 in 1995 to 5.4 in 1999, as life-extending drug therapies became available to more victims.

Another critical health issue is the birth rate among teenagers. Births for black girls aged 15 to 17 declined from 113 per thousand in 1990 to 50 in 2000. This drop is a very positive sign because giving birth at this age not only puts the child at risk but typically means the mother does not graduate from high school. The birth rates for white girls aged 15 to 17 declined as well – from 30 per thousand to 24.

EDUCATION

The state of the nation's schools is widely regarded as deplorable. But the statistics tell a different story. Average SAT and ACT scores increased for all ethnic groups in the 1990s. Moreover, school-completion rates have soared. In 1970, only 55 percent of white adults had graduated from high school; 30 years later, this figure was 85 percent. Among blacks, 31 percent had earned high school diplomas in 1970; by 2000, the figure approached 79 percent. Latinos lagged in this category. Still, high-school-completion rates did rise from 32 percent to 57 percent in the same period.

The numbers for higher education are equally encouraging. In 1960, only 7.7 percent of Americans over 25 had graduated from college. By 2000, graduates exceeded 25 percent, and the ethnic breakdown confirms that blacks are narrowing the gap. The proportion of black adults with college degrees has almost quadrupled over the last 30 years, rising from 4.4 percent to 16.5 percent.

Latinos remain far behind by this metric: some 10.6 percent had graduated from college in 2000, compared to 4.5 percent in 1970. But it's important to remember that a disproportionate number of Latinos are immigrants, and a substantial number are not fluent in English.

INCOME

While median earnings increased in the 1990s, the gains seem disappointing in light of the booming economy and substantial increases in the educational attainments of the labor force. The earnings of white women rose the most (15 percent) and earnings of Latino men rose the least (7 percent) with the gains for white men, blacks and Hispanic women falling between these two figures.

But again, the story looks different from other perspectives. Bouyed by increased female labor force participation and earnings, household incomes have risen impressively since 1980. Moreover, the gains have been recorded across the income distribution.

From 1980 to 2000, the median income of white households increased by 19 percent and the percentage of households with real (that is, adjusted for inflation) incomes less than $25,000 fell from 32 percent to 26 percent. The improvements were far more pronounced for black households. Median income increased by 39 percent, and the percentage of households below $25,000 dropped from 55 percent to 41 percent. Meanwhile, black households with incomes exceeding

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$75,000 increased from 5.3 percent to 13.7 percent. During this period, Hispanic households experienced a gain in median income of 23 percent, and the portion below $25,000 declined from 42 percent to 36 percent. The percentage earning above $75,000 more than doubled, to 14.7 percent.

Many critics rightly point out that inequality in the distribution of income has grown. But I would argue that absolute levels of income matter more than relative levels. And here, the signs are positive. The percentage of households with low ($15,000) and moderate ($25,000) incomes decreased. Incomes did regress between 2000 and 2002, but that probably reflects nothing more than the recession.

By the same token, many economists put more weight on the fate of the very poorest than on broader measure of economic well-being. But here, too, the news is good for the most part. After rising in the 1970s and 1980s, the portion of families living below the poverty line (in 2000, defined as a $13,740 income for a family of three and $23,533 for a family of six) fell substantially in the 1990s.

The poverty rate for the nation was 22.2 percent in 1960. Rising wages for low-skilled labor and a plethora of government income-redistribution programs reduced that figure to just 11.1 percent in 1973. From this low point, the poverty rate has roughly tracked the business cycle, increasing to 15.2 percent in 1983, declining to 12.8 percent in 1989, and rising again to 15.1 percent in 1993. It then declined steadily, reaching 11.3 percent in 2000. Poverty has been on the rise since 2000. But there is some indication that the longer trend is positive: the poverty rate in 2002, 12.1 percent, was lower than the rate in 1998, 13.3 percent.

HOUSEHOLD INCOME

HOUSEHOLD INCOME	MEDIAN (2002 DOLLARS)	PERCENTAGE OF HOUSEHOLDS EARNING UNDER 15,000	15,000-25,000	OVER 75,000
WHITE				
1980	$38,621	17.3%	14.5%	15.0%
1990	41,668	15.4	13.5	20.5
2000	45,860	13.8	12.2	26.9
2002	45,086	14.5	12.8	26.6
BLACK				
1980	22,250	36.5	18.7	5.3
1990	24,917	34.6	15.5	8.5
2000	30,980	25.2	16.1	13.7
2002	29,177	27.4	16.4	12.9
HISPANIC				
1980	28,218	24.7	17.2	7.1
1990	29,792	25.1	16.8	9.9
2000	34,636	18.2	17.8	14.8
2002	33,103	19.1	19.1	14.7

PERCENTAGE OF POOR IN AMERICA

	TOTAL	CENTRAL CITY	WHITE	BLACK	HISPANIC
1970	12.6%	14.2%	9.9%	33.5%	22.8%
1980	13.0	17.2	10.2	32.5	25.7
1990	13.5	19.0	10.7	31.9	28.1
2000	11.3	16.3	9.5	22.5	21.5

It is also worth noting the modest trend toward convergence among ethnic groups. The poverty rate for blacks fell from 33.4 percent in 1992 to 23.9 percent in 2002, while the poverty rate for Latinos dropped from 30.7 percent in 1994 to 21.8 percent in 2002.

By the same token, the socioeconomic forces concentrating the poor in central cities seems to have reversed. Paul Jargowsky of the Brookings Institution estimates that poverty in central cities rose from 14.2 percent in 1970 to 21.5 percent in 1993 as moderate-income families gained the means to get housing in safer neighborhoods. But it has since fallen to 16.3 percent (in 2000).

FAMILIES

In the 1960s, Daniel Patrick Moynihan warned

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of the breakdown in the black family. And his fears were largely borne out in following decades. But there are signs that the black family is coming back. The Census recently reported a decline in the proportion of black mothers who are not married, a drop from 47 percent in 1997 to 43 percent in 2002.

It is true that the marriage rate of adults (age 18 and over) has declined. For what it's worth, though, the decline in marriage was larger in the 1980s than in the 1990s. Moreover, there are signs of convergence among ethnic and racial groups in one key related category – the percentage of families with children in which both parents are present. While this figure declined slightly for white families between 1995 and 2000 (from 74.8 percent to 73.9 percent) it rose for both blacks (35.7 percent to 38.6 percent) and for Latinos (63.6 percent to 65.9 percent).

CRIME

Those who watch *Law & Order* reruns might assume that crime has been increasing. In fact, violent crime in America fell dramatically in the 1990s. The FBI data show that the murder rate has declined by almost half since 1980 (from 10.2 to 5.5 per 100,000). The largest improvement came in the latter half of the 1990s, from 9 per 100,000 in 1994 to 5.5 per 100,000 in 2000. The decline in rape began in 1993, dropping from 43 per 100,000 in 1992 to 32 in 2000. Robbery fell steadily from 1991 to 2000, from 273 per 100,000 to 145 per 100,000, with aggravated assault falling from 442 in 1992 to 318 per 100,000 in 2001.

Many factors contributed to the decline in crime, including demography (a fall in the proportion of the group most likely to be violent, men aged 18 to 24, in the population), more sophisticated policing tactics, longer sentences for violent offenders, the end of the crack cocaine epidemic, and increased economic opportunity for minority youth. Strikingly, crime has disproportionately declined in big cities. The total number of murders in New York City fell by 74 percent, from 2,245 in 1990 to 594 in 2003. Homicides in Los Angeles dropped by 54 percent from 1992 to 2003.

CENTRAL CITY REVITALIZATION

One of the most visible effects of the overall improvement in urban conditions is the revitalization of central cities. One seat-of-the-pants index is simply the change in population, which grew in each of the nation's three largest central cities in the 1990s.

Each of these cities has its own story. The population of New York increased by 9.4 percent from 1990 to 2000, a remarkable turnaround from the 3.5 percent growth of the 1980s and the 10.4 percent decline of the 1970s. Indeed, the city's population growth outpaced that of its suburbs – a rare occurrence in modern urban history.

Los Angeles is harder to evaluate since much of the city is functionally indistinguishable from the suburbs. For what is worth, though, the population of Los Angeles did grow by 6 percent in the 1990s in spite of factors that made it a less attractive place to live and work – notably, a major earthquake and downsizing of its aerospace industry.

The population of Chicago grew in the 1990s for the first time since the 1940s. This change was a modest 4 percent, but quite a contrast to 7.4 percent and 10.8 percent declines in the 1980s and 1970s respectively. Population growth was strong in the downtown areas as well as in the Northwest and Southwest areas of the city. And perhaps most encouraging, the population decline in many of the city's poorest areas halted.

The record for some of the nation's other

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old, large central cities is still mainly negative. Philadelphia, Detroit, Baltimore and Milwaukee all continued to lose population in the 1990s. However, the populations of San Francisco and Boston, as well as a host of cities in the Sunbelt, more than made up for their losses. In fact, 16 of the 20 largest cities (a group that includes non-Sunbelt Columbus and Indianapolis) gained population in the 1990s.

SUMMING UP

There are many ways to interpret change in a nation as large and diverse as the United States. No single (or single-dozen) measures can tell you all you would want to know about the evolution of the society and the economy. My goals here are more modest.

While there is a tendency to see disaster lurking, there is, in fact, much to be pleased about. Most people are safer, have more money to spend and can expect to live a lot longer than in the past. And the quality of life seems to be improving, even for those on the lower rungs of the socioeconomic ladder.

That's not quite a ringing endorsement of the status quo. Surely, though, it is sufficient reason to appreciate the resilience and essential vitality of American society. M

WILLIAM RIESER

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Retail

ERIC SWANSON/VEER

Using Retirement Savings As A Fiscal Tool

By John Crudele and Walter J. Williams

Think of the mechanism for keeping the United States economy on a growth track as a bicycle – a two-wheeler, as we used to call it. The wheels are conventional monetary policy and fiscal policy. Low interest rates grease one wheel, while a combination of tax cuts and government spending lubricates the other.

But, as any kid can tell you, there's a problem with two-wheelers. If something unexpected upsets the bike's balance – a pothole in the road, a neighborhood bully who jams a stick in the spokes – it can end up in a ditch.

This country's economy is still upright, and it could very well be moving at a good clip when these words reach print.

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RETAIL THERAPY

Still, there's little doubt that a variety of shocks – not to mention the malevolence of terrorists – have made our economy wobble in the past few years. And this makes us wonder what obstacle lies in wait down the road.

So maybe it's time to improve the stability of our economy by adding a third wheel.[1] In addition to cutting interest rates or taxes, Washington could offer people limited-time-only access to their retirement savings accounts without penalties or tax consequences when the economy is in need of a boost. This would augment private spending when the economy needs it, increasing demand directly for consumer goods and indirectly for new productive capacity.

And what works in one direction could work in the other. When the economy is overheating, Washington could increase the tax incentives for retirement plan contributions. This would give account owners a reason to spend less and save more, slowing the economy in the process.

We'll flesh out these ideas below. First, though, an acknowledgment: Some people with brains and/or political clout won't like the proposal. Wall Street won't be thrilled if money is coaxed out of stocks, potentially reducing the value of equities. And those who are (justifiably) worried that Americans aren't saving enough for retirement will fret that the plan will give families one more reason to ignore future needs.

But at a time when macroeconomic policy options have narrowed, all plausible means of offsetting the vagaries of the business cycle deserve exploration. Moreover, the downside isn't as disquieting as one might imagine.

Here's where our two-wheeler[2] has gotten us today.

The Federal Reserve has gone about as far as it can go with easy credit. Short-term interest rates – the rates controlled by Greenspan & Company – are as close to zero as is practical. Indeed, at its January 2002 meeting, the Fed's Open Market Committee explored what "unconventional policy measures" might be available in the event more aggressive recession-fighting measures were needed. Fearing the onset of a Japanese-style deflationary spiral, the Fed discussed options such as buying stocks with newly created money.

Congress has done its part, too – albeit for its own political reasons – by providing a heavy dose of fiscal stimulus. Americans have been treated to about $200 billion in tax cuts

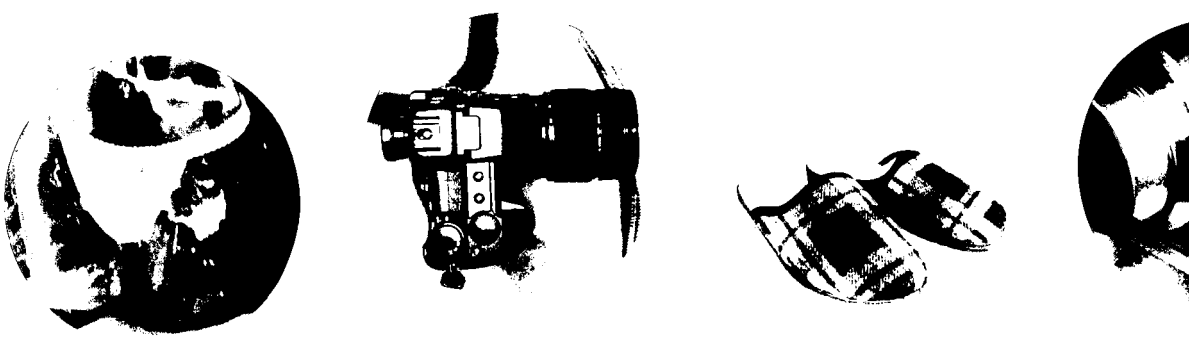

IMAGE SOURCE/VEER

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[1] *Patience; we're almost done with the metaphor.*
[2] *OK, OK; we're almost done with the metaphor.*

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over the past two years. One consequence, though, is that the federal deficit has risen to a record level.

Under normal circumstances, interest rates at an all-time low and a full-speed-ahead, damn-the-deficits fiscal policy would be enough to keep the American economy afloat. But the times are apparently not normal. Despite policies that might have been expected to add 200,000 to 300,000 jobs a month, we seem to be in the midst of a jobless recovery.

Chief executives are keeping an especially close eye on payrolls so Wall Street doesn't have an excuse to turn against their stocks (or their compensation). And even if they weren't so focused on cutting costs these days, a combination of technologically driven productivity change in service industries and the new enthusiasm for exporting service-sector tasks to places like India, Russia and Ireland would be slowing job growth. Then, too, there is the intangible issue of business confidence – executives' fear that sticking their necks out by adding employees could put them in sight of the guillotine.

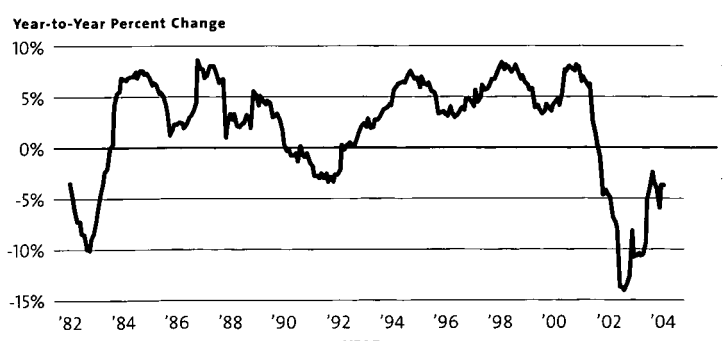
The trouble is, there isn't a bigger confidence buster than the failure of the fiscal and monetary bullets that have already been fired to slay the recession beast.[3] And more disappointing employment figures in the months ahead would undoubtedly deepen the gloom.

That brings us back to the idea of putting retirement cash in play. People don't have to feel especially confident to be induced to

[3] *Hey, at least it's a fresh metaphor.*

U.S. TREASURY RECEIPTS

12-MONTH MOVING AVERAGE, ADJUSTED FOR INFLATION



Year-to-year growth in Treasury receipts of 5 percent and above triggers new savings incentives and a tightening of savings liquidity.

Contracting year-to-year change in Treasury receipts triggers savings liquidity stimulus

SOURCE: U.S. Treasury, Bureau of Labor Statistics

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spend. They just have to be convinced that the temporary tax advantages offered by the plan made it worthwhile to accelerate purchases they would otherwise have deferred. Conversely, when spending needs to be dampened, the carrot of more generous tax breaks for folks who were prepared to delay spending and sock away cash for retirement could make a big difference.

TAPPING INTO $10 TRILLION OF PENSION RESERVES

Why focus incentives on retirement accounts? To paraphrase Willie Sutton, because that's where the liquid assets are. Private pension and retirement accounts represent the single largest unencumbered asset group held by families, and account for one-third of all financial assets. More than $10 trillion sits in these accounts; roughly $4.5 trillion of this is in various sorts of defined-contribution plans built on tax-deferral incentives.

The good news is that retirement account holders have the means to make high-ticket purchases if the incentives are right.

In broad outline, we would allow families to tap tax-deferred retirement savings to some specified maximum (perhaps $20,000 annually) with no tax consequences when the economy hit pre-specified recession triggers. If it proved practical, we would limit the use of the money to job-creating activities – that is, spending it rather than reshuffling it to other savings vehicles. Since those without retirement savings to cash in would lose out, the plan would ideally include a flat refundable tax credit of, say, $500, for those below some modest income threshold.

When the time came to slow the economy down – again, according to a pre-specified trigger – the amount of money that families could contribute to retirement plans would be ratcheted up. If stronger incentives to reduce spending were warranted, the plan might allow those who had previously made tax-free withdrawals to return the funds and claim a fresh tax deduction.

According to the Federal Reserve's 2001 Survey of Consumer Finances, 52 percent of families – some 39 million families in all – own some form of retirement account. And a separate study by the Congressional Budget Office estimated half of the work force in 1997 actively participated in tax-deferred retirement savings plans.

But the use of retirement accounts to shelter savings varies sharply according to income. The Fed estimated that only 13 percent of families in the lowest fifth of the income distribution had retirement accounts. The figure for the next quintile was 33.3 percent, while fully 88 percent of families in the top quintile took advantage of the big tax break. The CBO study showed that tax-deferred plan participants were generally married, were over the age of 30, and had incomes exceeding $22,500.

IMAGE SOURCE/VEER

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The bad news here, of course, is that the poor would miss out on the benefits from incentives keyed to retirement savings – which is why it would be wise to supplement the plan with alternative spending incentives at the low end. The good news is that retirement account holders have the means to make high-ticket purchases if the incentives are right.

With regular individual retirement accounts and 401(k) accounts, most money contributed by the earner is deductible from taxable income. No taxes are due on the principal or account earnings until funds are withdrawn. If the withdrawals are made before age 59½, they are not only taxed at regular rates, but also subject to a 10 percent penalty. Contributions to Roth IRAs are not tax-deductible, but withdrawals after five years are tax-exempt. Early withdrawals still are subject to the 10 percent penalty.

Our plan would eliminate both tax and

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penalty consequences for early withdrawals up to $20,000 per family per year, so long as the trigger mechanism was signaling recession ahead. Account holders could replenish their retirement nest eggs without further tax reduction. Additional incentives, however, could be offered to help accelerate the process. Roth IRAs would be replenished by allowing full tax deductibility of the replenished amounts.

There are already precedents for giving retirement plan participants limited penalty-free access to funds for a variety of uses – among them, first-time home purchases, higher-education expenses, health insurance premiums and medical emergencies. Our plan would sweeten the incentives by eliminating all tax liability on withdrawals when a recession was in the offing.

STIMULUS WITHOUT DEFICIT TEARS

We estimate that allowing up to a $20,000 per individual tax- and penalty-free withdrawal would lead to a savings liquidation of roughly $100 billion annually. This added spending could increase aggregate demand by roughly 2 percent as it worked its way through the economy. Although the figure is in the ballpark of recent tax cuts, there is good reason to expect that a greater percentage would be spent rather than saved – implying that it would generate more stimulus, dollar for dollar, than the Bush administration's tax cuts.

Further, unlike a tax cut, this stimulus would not lead to higher budget deficits in the year of the trigger. Since these are funds that generally would not have been touched otherwise, the immediate impact on tax revenues would be nil. Indeed, the approach would increase near-term budget revenues for two reasons. First, it would increase economic activity, and thus total income subject to taxes. Second, it would lead to a net reduction in deposits to tax-sheltered retirement accounts, and thus broaden the tax base.

THE VIRTUES OF AN AUTOMATIC PILOT

Congress and the president always have the discretion to change the rules governing retirement accounts. But it would not be practical to leave decisions about the activation of countercyclical retirement account incentives to the politics of the moment. What is needed to help regulate the timing is a trigger that responds automatically to changes in economic conditions, thereby providing a stable planning environment for savings and

IMAGE SOURCE/VEER

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spending decisions.

A prior effort at fashioning an automatic economic trigger was used in conjunction with the Gramm-Rudman-Hollings Act of 1985, which forced Congress to balance the budget unless the economy was in recession. The recession trigger: two consecutive quarters in which real GDP fell.

But GDP figures go through a series of revisions, and using the first set of numbers could be problematic. For example, GDP growth for January through March of 2001 was initially estimated in April 2001 to be 2 percent. Fifteen months later, that figure was revised into negative territory, belatedly recognizing that the economy was already in recession in the first quarter of 2001. Other widely used data, like payroll employment, also go through regular revisions and suffer from sampling and methodological issues.

What is required is a hard number that directly reflects underlying economic activity. U.S. Treasury receipts, which largely consist of tax collections and are reported monthly, are such a measure.

The figure shows monthly the year-to-year change in the 12-month moving average of Treasury receipts, adjusted for inflation. If negative year-to-year change were used as the trigger, the savings liquidity stimulus would have been activated during the double-dip recession in the early 1980s, the 1990-91 recession and the 2001 recession, generating trigger signals in July 1990 and August 2001 in the latter two periods. While the figure is not adjusted to remove the effects of changes in the tax laws, such adjustments could be made with little effect on the demonstrated trigger pattern.

The periods of economic boom, when tax deferral incentives could be increased to help prevent economic overheating and related inflation, appear to be delineated by year-to-year inflation-adjusted growth in Treasury receipts exceeding 5 percent.

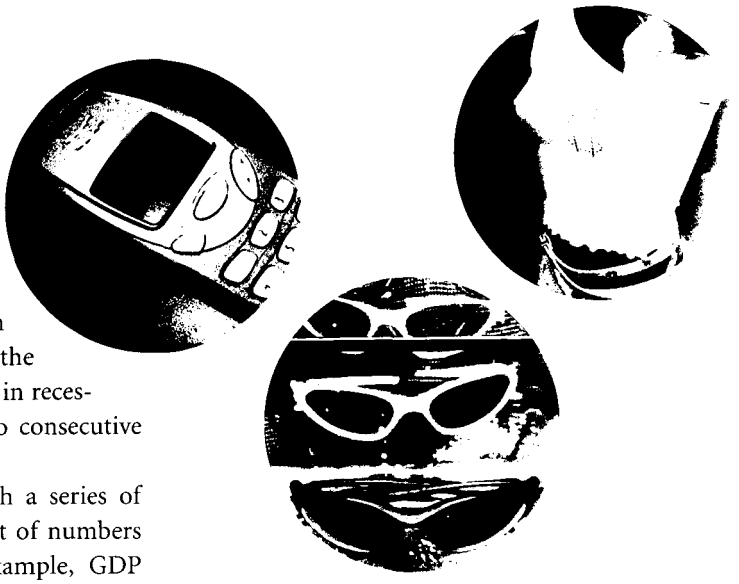

IMAGE SOURCE/VEER

We estimate that allowing up to a $20,000 per individual tax- and penalty-free withdrawal would lead to a savings liquidation of roughly $100 billion annually.

WALL STREET REACTION

Critics may fret that the withdrawal of cash from retirement savings accounts could trigger a slide in equity prices. But we believe that Wall Street really has more to gain than to lose from the plan, particularly if the savings stimulus action gets a sluggish economy moving.

Individual holdings of stocks and mutual funds outside of retirement accounts are

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Taming the business cycle should have a positive effect on saving in the long-term, since enhanced tax incentives for retirement savings would be provided in better economic times.

double those inside retirement accounts. Accordingly, the greater concern on Wall Street should be that a sagging economy will trigger broader selling of equities. By the same token, if one believes that the markets are rational – that the value of equities is driven by the expected profits earned by corporate America – any effective countercyclical plan that increases corporate earnings should increase stock prices.

BUT WE DON'T SAVE ENOUGH AS IT IS

It is conventional wisdom that Americans save too little. So, wouldn't a program to liquidate savings make a bad situation worse?

First, take a closer look at the premise that Americans don't save enough. Savings statistics from the primary source, the Bureau of Economic Analysis' National Income and Product Accounts, are based on a tower of assumptions. Moreover, comparing the numbers for U.S. personal saving rates against the rest of the world requires another host of assumptions.

In a November 2003 study of baby boomers' retirement prospects, the Congressional Budget Office took apart the traditional analysis of the personal saving rate. It noted that baby boomers, who had been blamed for the declining saving rate, actually were saving as much as their parents had saved at comparable periods in their lives. Moreover, alternatives to the NIPA measure of savings suggest that Americans are far thriftier than generally supposed.

In any event, the effects of the stimulus side of our proposal on savings would be temporary and reversible. Taming the business cycle should have a positive effect on saving in the long-term, since enhanced tax incentives for retirement savings would be provided in better economic times.

A SYSTEM PUSHING ITS LIMITS

Recent tax cuts and spending increases have injected demand into the economy and stimulated growth – but at the cost of sharply increasing the federal budget deficit. Concerns that the deficit is now "structural" rather than cyclical – that the budget would be far out of balance even if the economy were operating at peak capacity – have also been a factor behind the recent rise in long-term interest rates and weakness in the dollar. What's more, the Fed has pretty much run out of conventional monetary policy responses to promote growth.

That's why Washington needs another policy instrument – and preferably one that serves as an automatic stabilizer to lean against the winds of recession and overheating. We don't pretend to have worked out the inevitable kinks in our proposal to harness retirement account liquidity to the task. But we are convinced that it is a promising direction to explore if we are to sustain economic growth in these uncertain times. ▣

IMAGE SOURCE/VEER

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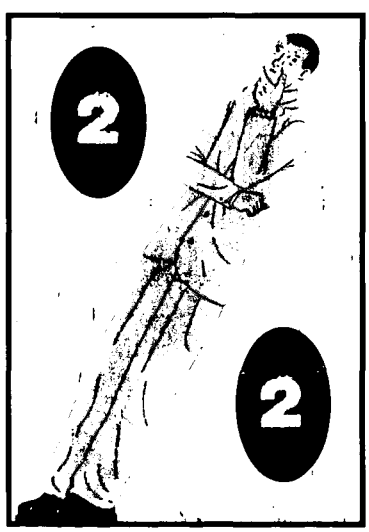
The Two Percent Solution

ILLUSTRATIONS
BY DAN PAGE

In an era in which journalists generally treat politics, government and public policy as little more than spectator sports – who's winning, who's losing, who will make it to the majors – Matt Miller is the serendipitous exception. His syndicated column explores everything from education vouchers to ageism. His weekly talk show on public radio, *Left, Right and Center*, treats listeners like adults. His first book, *The Two Percent Solution**, asks why the leaders of the globe's richest democracy are so timid about addressing societal problems, and explains how a modest redirection of resources – just 2 percent of GDP – combined with commonsense political reform could make a world of difference. Here, we offer an excerpt analyzing Washington's policy anemia and outlining a simple, economically efficient and relatively inexpensive way to raise the incomes of the working poor. — *Peter Passell*



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From schools to health care, from wages to campaign finance, when we scratch both parties' "bold plans," we find far less than meets the eye. Why do our leaders offer symbolic proposals to signal that they "care" about an issue, or to show whose "side" they're on, rather than ideas that might actually fix things?

Five main forces mesh to produce today's dysfunctional debate. Together they have yielded a "debate" so remote from real answers and so infected with double-talk that citizens turn away in disgust.

THE PARALYSIS OF PARITY

The defining feature of American politics in recent years has been the remarkable parity between the parties. You can't get closer than the presidential tie in 2000. And even the hype over the Republican win in the 2002 midterm elections masked the fact that we continue to have narrow majorities in Congress.

Yet periods of closely divided power are unusual in America. Our system of government has generally favored the creation of effective majorities. Think of FDR and the New Deal coalition, which lasted from the 1930s until it gave way in the late 1960s under the strains of Vietnam and the backlash against civil rights. Ronald Reagan's huge electoral victories ushered in a period of conservative power from 1980 to 1992.

Most analysts view eras of closely divided power as periods in which one system of effective majority has broken down and the next system of effective majority has not yet come into being. In this view, the 1990s were transitional: Reagan's majority broke down, but Bill Clinton couldn't get the Democrats to the promised land. Today the struggle continues.

In eras featuring a dominant ideology,

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like Lyndon Johnson's or Ronald Reagan's, there's an obvious mandate for ambition. By contrast, political professionals say, in eras of parity voters don't tend to think as big – nor are they invited to do so by politicians, who fear pushing beyond whatever fragile consensus may exist.

At the presidential and statewide levels, today's parity also breeds a maniacal focus on "swing" voters, that narrow universe of uncommitted citizens who (once we move past safely gerrymandered congressional seats) determine American elections. Democrats know they'll get union members and minorities and most women; Republicans know they can count on gun owners and religious conservatives and small businessmen. But those groups, and their brethren in each party's coalition, leave things deadlocked. The people left over decide who wins.

The result is a risk-averse game of inches, driven by the calculation that the right tactic – a dash of tax cut pandering here or Social Security demagoguery there – can lure the two or three points to put a candidate over the top. Such small-bore maneuvering not only fails to inspire voters, it's also inhospitable to serious policy ideas. And the "mandates" emerging from such contests are trivial.

When elections come in this era of parity, two strategies are at work simultaneously – strategies whose contradictions help reinforce the primacy of symbolic appeals and policy orthodoxy. At the presidential (and statewide) level, we see candidates like Bill Clinton and George W. Bush governing and campaigning in ways that are consciously centrist, seeking to assemble broad coalitions and distancing themselves from their base's most alienating traits.

But in the congressional trenches each party's base remains king. Candidates focus on which "hot buttons" to push or "red meat" to throw to bring the faithful to the polls. These groups tend to have strict ideological litmus tests. Any attempts to blend liberal and conservative ideas can run afoul of these demands.

DEMOCRATIC TIMIDITY AND CONFUSION

If parity gives American politics its overarching "game of inches" quality, the Democrats have special fears and reflexes that drive

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them to deeper levels of timidity and confusion. They start with the psychic scar of the Clinton health care fiasco of 1993-1994, which cost the party control of the Congress for the first time in 40 years and taught a searing lesson about the risks of trying to lead public opinion rather than following or accompanying it.

This timidity has been reinforced by the increasing importance of suburban voters to the Democrats, a key constituency as the party shed its Great Society image as the champion of poor minorities offering little to mainstream America. Given how poorly Democrats do with white men in particular, the role of suburban women to Democratic victories today cannot be overstated. Suburban women gravitate toward the Democrats because they like the party's focus on education, health care and the environment. They share the Democrats' acceptance of modern gender roles, and find conservative cultural intolerance off-putting. But suburban women also believe in fiscal prudence.

The irony is that the Democrats deserve to be considered rock-solid on fiscal prudence, because they recently delivered the most fiscally responsible era in memory. Bill Clinton inherited record budget deficits and bequeathed record surpluses. He took over a government that spent 22 percent of GDP under presidents Reagan and Bush, and left office with spending at 18.5 percent of GDP. What more could suburban women want? Yet the Democrats can't seem to get credit for these accomplishments, or to shake lingering doubts that they're plotting to sneak off and go on a spending spree.

In addition, Democrats have split into two incoherent and suspicious camps with mirror-image philosophies that complicate any attempt to regroup. Broadly speaking, "Old" Democrats have traditionally liberal (if prudently disguised) spending ambitions but loathe market-friendly approaches to public problems. "New" Democrats have market-friendly instincts but are afraid to put up money equal to the size of today's problems.

In their hearts, Old Democrats – think Ted Kennedy or the late Senator Paul Wellstone – view the "fiscal responsibility" and "balanced budget" themes as political necessities with scant policy merit. New Democratic positioning may win statewide and national elections, they concede, but the New Democrats have lost their souls.

Old Democrats see market-friendly ideas – like using tax credits to extend health coverage – as deeply suspect. They feel you haven't guaranteed anybody anything unless government has done so itself, because private firms are too self-interested to protect the public interest. Old Democrats also have political reasons to prefer direct government fixes over diffuse solutions involving multiple actors. "That may be good policy," Old Democrats say to New, "but how do we as a party get credit for something that isn't seen as a nice packaged benefit with a ribbon around it that we've given to the fortunate taxpayer."

New Democrats, whose numbers include nearly every current presidential aspirant, think Old Democrats are fuzzy-headed on economics. Yes, balanced budgets in the 1990s may have been smart politics, they say, but they were also needed to lower interest rates, increase national savings and investment, and thus boost productivity and growth – relationships they feel the economically illiterate Old Democrats don't appreciate. Instead, Old Democrats wrongly act as if economic growth "just happens" and treat politics mostly as a way to transfer resources to America's have-nots. The reality, say the New Democrats, is that unless the economic "pie" keeps growing through rational policies, the nation can't

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afford to pursue social justice.

New Democrats also realize that harnessing market forces for public purposes can be the most effective policy, as well as the only way to get bipartisan support. But New Democrats are generally petrified of ideas that require serious spending, and so their ideas are rightly criticized for being token or symbolic. A prime example was the much-hyped but puny $200 million school-to-work initiative early in the Clinton Administration, which, as one Old Democrat quipped, "ended up helping dozens if not hundreds of people and then got killed."

Yet New Democrats say they're doing the best they can in a world where spending is politically risky because voters already think their money is being wasted. New Democrats vow not to give the GOP any rope to hang them with.

Democratic timidity largely comes down to this fear. "They're convinced people wouldn't buy what we believe the country really needs," said Bill Bradley. "So we have to say what we want them to hear – that we're with them," but without offering policies equal to their problems. This pattern of what Bradley calls "the big rhetoric and the little mouse" was a winning formula for Clinton after 1994 – or, more precisely, a sufficient formula for political survival. Bush has copied the technique on domestic policy. "That's cynicism," Bradley concluded. "And that's infected the political process."

The trouble is that Bradley tried to break out of the straitjacket in the 2000 primaries, and he was neatly diced up and disposed of by Al Gore. Bradley's campaign represented the first road test of a potential synthesis of Old and New Democratic thinking. Yet Bradley faced nearly impossible odds. As a sitting vice president, Gore was the presumptive nominee in the eyes of the Democratic establishment and enjoyed enormous built-in advantages. Gore also decided that the most effective way to take Bradley out was to swing the New Democratic "fiscal responsibility" club.

New Democrats are generally petrified of ideas that require serious spending, and so their ideas are rightly criticized for being token or symbolic.

Did Bradley's experience prove that thinking big while offering "ideologically androgynous" solutions is a loser? Or was Bradley's circumstance unique, meaning that a new candidate in a wide-open field could carry and defend such an agenda and unite the party? Much depends on how the party's presidential aspirants answer this question.

The final forces shaping Democrats' behavior are their profound phobias about taxes and defense. The tax story is simple. In 1984, the Democratic presidential nominee Walter Mondale stated that he would raise taxes to rein in the deficit. His reward for being a "truth teller" was to lose 49 states in the general election.

On defense, Democrats feel they're on equally treacherous terrain. President Bush has proposed the largest defense increase in history, which would lift Pentagon spending from the $300 billion he inherited to $470

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billion over the next few years. This would make the defense budget more than 50 percent higher, after adjusting for inflation, than it was on average during the Cold War. Many top Democrats privately think the sums Bush has proposed are insane and represent a cynical strategy to use September 11 to crowd out domestic spending. But the key word here is "privately."

Candidates like Republican Senator John McCain, with impressive records of service and sacrifice, have obvious standing on defense and can therefore be critical of Pentagon policies. The classic example of such a leader was President Dwight D. Eisenhower, the original scourge of the military-industrial complex. "The problem is that there are very few Democrats who can speak with that kind of credibility on defense issues," Indiana Senator Evan Bayh said, "and so they're all running for cover." This fear is even more potent in the wake of 9/11, when the Democrats' broader vision gap on national security strategy has left them vulnerable in ways that squabbles over defense spending would only compound.

"There are these rules in politics," explained Carter Eskew, a Democratic consultant, "one of which is you don't try and have a debate on the other guy's turf." But here's the problem. The Democrats have painted themselves into a corner. They can't spend. They can't tax. They can't take on defense even if Bush's plan is excessive. As a result, even if the Democrats win, they can't do anything, except offer symbolic appeals and make-believe fixes. If you're a Democrat, sometimes the fog is so thick you can't even see the myopia.

In the end, the party has been reduced to what Lawrence Summers, the former Clinton Treasury Secretary who now serves as president of Harvard University, called a "reactionary liberal strategy." "Democrats like arguing that the Republicans will take it away, rather than arguing that we will do 'X,'" Summers said, "because they've found that to be a better and a more convincing strategy."

REPUBLICAN INDIFFERENCE: HYPOCRISY, PRINCIPLE – OR DEEP PSYCHIC ANGST?

If the Democrats are trapped by fear, something more mysterious is at work with the Republicans. F. Scott Fitzgerald wrote that "the test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function," but no one ever suggested Fitzgerald should run the country. Yet the contradiction I kept bumping up against in conversations with George W. Bush's cabinet, top Republican officials, and other conservative thinkers and activists left me stumped. Most of them insisted they were as concerned with equal opportunity and the problems of disadvantaged Americans as were Democrats, and resented the way their party was caricatured as heartless or indifferent.

But I had to tell them that I couldn't square their avowed concerns with Republican budget priorities, unless they honestly believed that we could address the problems facing the uninsured, disadvantaged children and the working poor without new federal money. This, after all, was the result of Bush's tax cuts, defense hikes, and deficits (along with the reality that neither party, rhetoric aside, is prepared to reallocate much of the rest of federal spending). And here's the surprise: when you frame it this way, and press them on it, most Republicans do not in fact believe these problems require no new money.

So what's going on? I see six possibilities:

They don't really mean it. This is the Pure Hypocrisy theory and it's what many Democrats believe. "They have no interest

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whatsoever," said Howard Dean. "They're just going to put out whatever rhetoric they have to in order to try to fool the American people into thinking that they care." But I don't think this is as big an explanation as Democrats presume. Undistilled hypocrisy is rare.

They mean it, but these aren't their voters. This is the Raw Politics theory, and it makes a lot of sense. Whatever noble thoughts may lurk in the Republican heart, these issues and these voters are not what get them elected. "Conservatives haven't really thought the problem through because their own political interests are not served," said Bill Bradley. "Their attitude toward this subject politically comes from showing enough leg to convince the independents they would like to attract that they're not Neanderthal."

They mean it, but government can't make things better. Much of this sentiment is the "money's not the answer" mantra. "We've spent $5 trillion on these people since the 1960s," went the conservative rallying cry during the debate over welfare reform in the mid-1990s, "and they're still on the dole!" But conservative outrage here has always been highly selective. Republicans seemed to feel money was precisely the answer when they enacted a generous living wage for corporate farmers in 2002 while refusing to consider the same for millions of struggling workers. The better conservative position here is a healthy skepticism about the efficacy of government action, since many programs have had spiraling costs and unintended consequences.

They mean it, but it's crazy to spend more money without reforming the system. First, you can agree on the need for systemic reform (as I do) and also believe that money can help bribe the interest groups involved to get it. Nor (again) do conservatives apply their principles consistently. Studies show, for example, that in many functions that could be privatized – like housing, payroll processing, travel and inventory management – the Pentagon wastes up to $30 billion a year compared to more efficient private sector practices.

They mean it, and over the long run things take care of themselves. This is the argument for the genius of capitalism, and Milton Friedman is its most cogent advocate. "Everything starts out as a luxury for the rich and ends up as a necessity for the poor," Friedman told me. This pattern of capitalism, Friedman argued, has produced higher living standards for more people than any rival form of social organization. Friedman is undeniably right over the long run, a fact that liberals need to acknowledge. But this long-run truth can be corrosive. The conviction that the invisible hand will make poor folks better off in the next century lets conservatives off the moral hook today.

They mean it, but they don't act on it – and deep down this really bothers them. Here's where it gets interesting: in fact, this last option in many ways incorporates the rest. In 1957 a psychologist named Leon Festinger published a book called *A Theory of Cognitive Dissonance*. Festinger posited a simple theory to explain certain aspects of human motivation. An individual strives for consistency within himself, Festinger said. What catches our attention are the exceptions to such consistency. A person knows smoking is bad for him yet keeps smoking; people commit crimes even though they are likely to be caught. Festinger argued that such inconsistencies are rarely accepted psychologically as inconsistencies by the persons involved. Instead, they attempt to rationalize things in ways that render them consistent. The smoker who keeps smoking even knowing it's bad for his health, for example, may also feel that if he quit he'd gain so much weight it

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The right has developed a series of pseudo facts and incomplete arguments to protect themselves from facing the contradiction between a moral self-image that includes concern for the disadvantaged and budget plans that reveal this concern to be a fraud.

would be worse for his health. So continuing to smoke remains consistent with his ideas about smoking.

But people can't always explain away such inconsistencies. The existence of such cognitive dissonance, being psychologically uncomfortable, will motivate the person to try to reduce the dissonance and achieve consonance. A fair-size chunk of the Republican establishment, I'm convinced, is coping with a serious case of cognitive dissonance. As a result, a fair amount of conservative intellectual activity is devoted to reducing this dissonance. Operating in a cocoon of like-minded souls, the right has developed a series of pseudo facts and incomplete arguments that they sincerely believe in order to protect themselves from the discomfort that would come from honestly facing the contradiction between a moral self-image that includes concern for the disadvantaged and budget plans that reveal this concern to be a fraud.

Let me be the first to say that most of us couldn't get through the day without a little dissonance avoidance. But on the issues we're discussing, the GOP's dissonance is striking – and a barrier to progress. What persuaded me that this phenomenon was central to Republican behavior was the way certain selective "facts" popped up (or didn't pop up) in my dealings with top conservative thinkers and institutions.

Take Ed Gillespie, an influential lobbyist and strategist who recently became chairman of the Republican National Committee. I met with Gillespie in his Washington office and laid out the Two Percent Solution concept. "My first instinctive reaction is that 2 percent on the dollar sounds attractive," Gillespie said, "except that we're already taking 40 percent on the dollar of national income for government purposes, so it's really 42 percent."

If government were in fact taking 40 percent of national income, this might give one pause. But it's not. Federal spending and taxation is a little under 20 percent of national income today. When you toss in states and localities, overall receipts are 28 percent of GDP. Two percent on top of that – even assuming we were financing it all through taxes, which we won't be – doesn't seem nearly as big a deal. (The average among the major industrial democracies is 44 percent.)

The good news in all this is that where there is dissonance there is hope, because it means that people with consciences are suppressing or avoiding certain aspects of reality that if acknowledged would tend to undermine their self-image. I'm not saying true-blue conservatives will happily submit to my brand of "fact-based" re-education anytime soon. But I don't think it's unreasonable to think a critical mass of centrist Republicans can be coaxed into weighing new ideas

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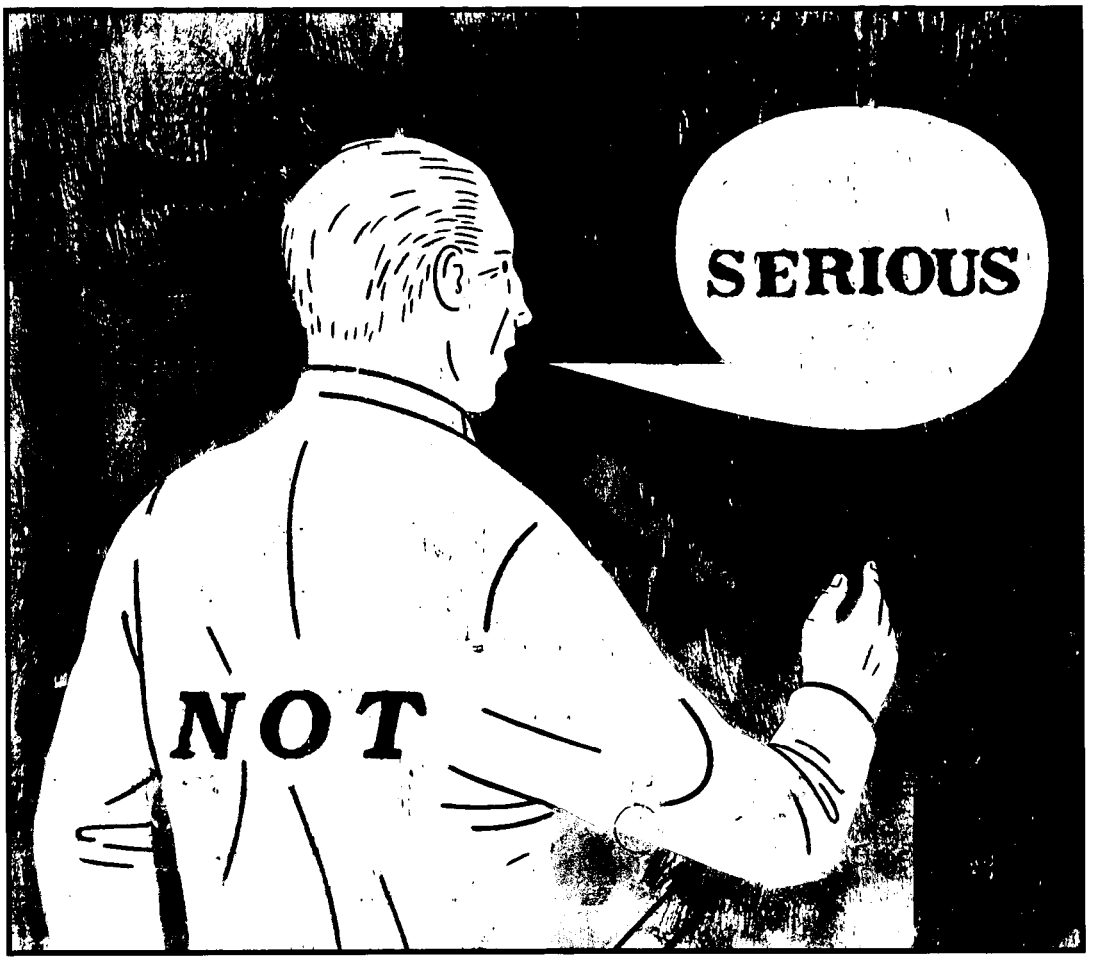

– especially if Democrats, as a sign of good faith and intellectual honesty, are willing to re-examine their own antique thinking.

THE MEDIA: IT'S THE STENOGRAPHY, NOT THE IDEOLOGY

Let's review where we are when it comes to getting serious about such problems as the uninsured, urban schools, or the working poor. Democrats, thanks to the shadow of Clintoncare, fiscally prudent suburbs, internally incoherent camps, and fears about defense and taxes, are timid and confused. Republicans, owing to some blend of principle, politics and psychology, are largely indifferent. How do our most influential media outlets then contribute to our lack of seriousness? By faithfully reflecting and choosing not to challenge the boundaries of debate set by the two major parties.

Many people would say this is exactly what the press should be doing, especially in its news pages as opposed to its editorial pages. This means the usual carping about the media misses the point. Conservatives say the mainstream media is liberal, and they're right. But that's not what's interesting. The interesting question is this: if the media is so liberal, why has America's political center of gravity shifted so dramatically to the right in

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the past two decades? The answer is that the news coverage of influential national media outlets is shaped more by stenography than by ideology.

"News" is largely defined as what public officials say and do. The poles of debate on major issues are thus set by the mainstream Republican position (today set by the Bush Administration) and the mainstream Democratic position. The national press faithfully reflects these two poles, and the 50-yard line in American politics is between them.

Look what's happened in the last decade or so. Before 1994 "the left" was more to the left, with Democrats talking about such things as universal health coverage, and with the right opposed. After the Clinton heath care fiasco and the Republican ascent in Congress, the left moved rightward for all the reasons we've discussed. The right, emboldened, moved further to the right – aggressively calling for bigger cuts in marginal tax rates, the elimination of the estate tax, et cetera. And so as the official poles of debate shifted, so did the political center of gravity – even though all of these events were filtered by the "liberal" media.

While stenography as a news value may seem preferable to a situation in which top national news outlets pursue their own untethered agendas, it also brings a clear downside: in times when neither party is serious about addressing major problems, stenography ensures that public debate remains impoverished. Stenography gave us a 1988 presidential campaign, for example, without a peep about the burgeoning savings-and-loan crisis. Since both parties were knee-deep in blame, neither wanted to discuss it. Without candidates bringing it up, the national media didn't pursue the story, either.

To be sure, smaller print outlets challenge the official debate. The rise of conservative voices on talk radio and cable television has also had some impact on the tilt and tenor of public life. But these outlets have very little influence on what is considered to be "news" compared to the judgments made by the editors of *The New York Times* and *The Washington Post*, and the producers of the major television networks – and these top outlets do not generally feel it is their proper role to challenge the official boundaries of discussion.

Len Downie, executive editor of *The Washington Post*, told me that the Post certainly doesn't conceive of its general news coverage as being confined to what is said or identified by the parties. But Downie said that when it comes to solutions, there may be a difference. "You're talking about whether or not the coverage that we do of the proposals to do something about it are limited to the framework of what the two parties have proposed, and I guess that's possible," he said.

Their rare crusades aside, then, the editors running influential outlets like *The New York Times* and *The Washington Post* do not see their jobs as systematically setting some broad public agenda, even though they're aware that on many individual issues they end up defining that agenda as a byproduct of "just putting out the paper" – particularly via stories they choose to place on page one. "I don't set out each day to create a national agenda," said Gerald Boyd, the managing editor of *The New York Times* when we spoke in 2002. "It's important to me that we're relevant to our readers."

In other words, if Democrats are too cowed to push more ambitious domestic goals, the "liberal" press isn't going to do it on their behalf. The national press, despite its power and occasional hobbyhorses, sees its role as "witnessing," as serving up a "daily diary of debate," as offering "a platform for

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The honest answer, which flies in the face of your sixth-grade civics class, is that campaigns are a dueling series of pseudo events, misleading arguments and symbols managed by candidates in order to gain power by attracting the support of 50 percent-plus-one of those citizens who bother to vote.

independent inquiry and investigation" – but not as setting the terms of public discussion. There's a related reality to press coverage when it comes to campaigns: if candidates do put forward ambitious ideas, the top news outlets generally aren't equipped or inclined to assess them.

Note the depressing cycle we've sketched. First, our leaders generally feel it's too risky to lead in campaigns. Next, many in the press feel you can't really look to them during campaigns to make sense of what rival policy agendas might mean for the country. So you can be forgiven for asking what campaigns are for. The honest answer, which flies in the face of your sixth-grade civics class, is that campaigns are a dueling series of pseudo events, misleading arguments and symbols managed by candidates in order to gain power by attracting the support of 50 percent-plus-one of those citizens who bother to vote. Can we (and the press) change that in ways that might help us solve our problems?

We're getting ahead of ourselves. For now the important point is that stenography journalism mirrors the boundaries of official debate. Even though the press is largely liberal, if official debate has moved to the right, that's where the national debate will be. Although conservatives often have legitimate gripes about one outlet's skewed page-one story or another's liberal spin on a poll, they shouldn't whine. When stenography trumps ideology, so long as conservatives keep the left cowed, they win.

THE MONEY SKEW

If the press mirrors official debate, political money warps it. "The boundaries of debate are controlled by the amount of money that is put into the political system by the controlling interests," Senator John Kerry of Massachusetts told me. Every issue has these organized, well-funded groups. In health care, for example, it's the doctors, the hospitals, the insurance companies, the HMOs. "Can you challenge those boundaries?" Kerry asked. "The answer is yes.... But you want to challenge them intelligently by figuring out what the fears are and the tendrils of the resistance that is motivating that money, and seeing if you can harness that energy in a constructive way."

The money chase (a) puts sensible policy options off-limits, (b) turns politicians' attention to wealthier Americans and business interests, (c) allows politicians to shake down businesses for campaign cash, and (d) discourages promising candidates from running for office.

Take policy options first. Smart liberals know that giving trial lawyers unfettered license to sue HMOs isn't really the way to improve health care. Campaign fund-raising

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habits, however, drive Democrats to push bad policy here (allowing endless suits in a "patient's bill of rights," for example) to keep the plaintiffs' bar happy – just as Republicans wrongly sanctioned the looting of California taxpayers by their Texas-based energy pals.

Beyond the explicit way the money chase takes options off the agenda is the subtler way the process alters the perspective of politicians – particularly Democrats, once viewed as champions of the underdog. My theory is politicians complain about raising money, but the really good ones are usually not themselves independently wealthy. By raising money they associate with a whole new class of people and they like it. That is the most corrupting aspect of this process.

The usual assumption about the evil of political money is that lawmakers are in effect being bribed to vote. It doesn't work that way. "The more serious problem," said Norman Ornstein of the American Enterprise Institute, "is people in positions of influence in government shaking down donors, using the power of the state to engage in a protection racket."

Usually the financial interests on either side of big commercial legislation – think banking or telecommunications or insurance – fight themselves to a stalemate. Policy ends up being calculated to make sure legislators can keep the contributions coming the next time around. Membership on the committees that handle such legislation is viewed as a career boon because of the outsized fundraising prospects they offer.

Finally, at every level, the "money primary" determines which candidates will be heard at all. The most striking illustration came in the 2000 Republican presidential race, when in theory the field should have been wide open. By July 1999, seven months before the first primary vote in New Hampshire, George W. Bush had already raised $36.3 million, compared with $4.1 million for John McCain, $3 million each for Elizabeth Dole and Dan Quayle, and $2.2 million for Lamar Alexander. The big-name Republicans started dropping out left and right. By the time New Hampshire voted, McCain was the only serious rival left.

THE TYRANNY OF CHARADES

The upshot of the forces we've discussed – electoral parity, Democratic timidity, Republican indifference, media stenography, and the warping effect of campaign cash – is a debased political culture in which potential answers to our major domestic problems cannot find expression. Even if some factors shaping our leaders' calculations seem understandable in isolation, when you add them up we're left trapped in an elaborate charade. Since our leaders can't or won't talk about what it would take to make serious progress on health or schools or wages or campaign reform, they pretend they're serious as a way of communicating their good intentions and letting us know which "side" they're on. Every player in the system knows this is what is taking place, but no one lets on. The press knows it, too, but feels obliged to report it straight. Public life becomes a complex and mystifying con – not a search for solutions, but the pretense of a search for solutions as a means of jockeying for power.

Not only is this tyranny of charades corrosive for the political people caught up in it, it also subjects citizens to an endless stream of orchestrated hoaxes that sours them on public discussion altogether. The tools of modern political campaigns are deployed on behalf of every feud. Generally these "tools" involve spreading a fair amount of half-truths expensively across the nation in the hope they will stick and shape policy outcomes.

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Pharmaceutical lobbies, for example, fund ads featuring gray-haired actors who fret that Democrats' plans to add prescription drugs to Medicare could kill biomedical research – a fear on which no struggling real-life senior has ever uttered a peep. Democrats scream that schools will be gutted by Republican budgets, a mathematical impossibility when federal spending accounts for barely 7 percent of overall education funding.

The ubiquity of preposterous claims helps explain why so many people tune out of public life.

If the landscape is littered with perversions of truth and logic that poison our political culture, a few core scams need to be repeatedly underlined on each side for their special toxicity. Take conservatives first. The cardinal Republican sin is the party's ceaseless drumbeat for deeper tax cuts when Republican leaders know full well that the baby boomers' retirement can't be funded with today's expected revenues, that further long-term tax cuts only deepen that hole, and that marginal federal tax rates in today's range are simply not an impediment to robust growth (as the 1990s proved).

Democrats harbor their own deceptions. Liberals insist that only government can be trusted to provide services directly, when it's perfectly possible (and often preferable) for government to fund a service's availability without delivering the service itself. Worst of all, Democrats are addicted to Social Security and Medicare demagoguery, assailing the GOP for plans to "privatize" America's most successful social programs. Yet on Social Security, for example, the most any GOP plan (usually offered in tandem with New Democrats) seeks to do is give workers a chance to put 2 percent of today's 12 percent Social Security payroll tax into accounts they control. There are pros and cons to such a scheme, but leaving Grandma eating cat food in the street isn't among them.

The clash of philosophies behind this bipartisan dissembling is profound, but the real stakes are different than the rhetorical smoke screen. This is best illustrated by the perennial war over "class warfare." Every time Republicans propose a big tax cut, a Washington ritual unfolds. Democrats produce a table showing to what extent Americans at various income levels stand to benefit. "Class warfare!" the Republicans shout back.

Let's put aside labels for a moment and cut to the underlying question that explains this divide but that is never explicitly asked: is the distribution of income produced by the free market presumptively moral? People who say "yes" tend to believe there's a necessary connection between accepting markets as the best means of organizing economic life and accepting the results that markets produce as making moral sense.

People who say "no" start from a different premise. Markets are a human construct, they say, with an infrastructure of property law, contract law, central banking, and myriad other mechanisms devised by the mind of man to serve human purposes and social goals. Given how heavily these factors influence the distribution of income and wealth, they argue, it makes no sense to think that market outcomes could be presumptively moral.

Now step back into the contemporary tax debate. If you're a "markets are presumptively moral" type, you're almost certainly in favor of President Bush's tax cuts. Government would simply be giving people their own money back.

If you don't think markets are presumptively moral, you probably oppose Bush's tax plans. But when Warren Buffett, Bill Gates' father, Peter Peterson or Robert Rubin – all of whom would benefit hugely from President

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Politics has always to some extent involved choosing the caricature of reality that most closely approximates our values.

Bush's tax cuts – oppose them, it's not because they hate, resent or envy "the rich." Rather, they oppose them because they don't think tax cuts mostly benefiting those already well off should be a national priority.

The stakes are clearest on GOP calls to end the estate tax. Is it right to eliminate the estate tax entirely for the few thousand extremely wealthy heirs who bear its brunt?

The answer depends on what you think politics should be about. It's easy to feel, as former Bush economic adviser Lawrence Lindsey told me, that when you've been taxed once when you earned the money, and again after you saved it, seeing the feds swarm in for one last bite after you're dead takes matters too far. But that shouldn't end the debate. Over the past two decades the best-off Americans have thrived immeasurably. We should thus compare a $30 billion annual rebate for a handful of heirs (rising to $60 billion after 2011) with what that same sum could do for, say, America's 42 million uninsured, or poor children without preschool opportunities. In that context, making sure that a billionaire's kids will be able to divvy up the full billion, rather than have to scrape by with only $500 million or so, hardly seems pressing.

As a matter of political strategy, the right's "class warfare" salvo is an attempt to delegitimize such a discussion and rule out policy trade-offs that explicitly weigh America's unmet social needs versus the moral status and claims of those seeking further tax relief. If Republicans want to delegitimize all talk of the distribution of income in public policy, Democrats want to scare people into embracing the succor that only a benevolent government can provide. As a result, both parties keep pressing on us a cartoon choice between "free markets" and "government" that insults our intelligence, when the question is always about striking the proper balance.

The curious thing is that each side in this standoff feels aggrieved, convinced that the other plays ruthlessly in ways they wouldn't stoop to match and weren't cut out for anyway. Meanwhile, the frequent socializing across party lines that 30 years ago helped foster the empathy and friendship that made bipartisan cooperation easier has largely vanished. In its place is the deadly litigiousness of modern Washington, where small fortunes in legal fees are regularly borne by officials under dubious investigation from political rivals, a state of affairs that breeds new levels of bitterness that are hard to transcend or forget.

It's not always clear how we should judge our leaders amid this maddening mess. It's easy, on the one hand, to be outraged. On the other hand, what can individual officials do to turn a tide of disingenuousness that existed long before they took up their place on the public stage? This isn't to let them off easy, only to wrestle with what angle of vision seems fair.

What should we have thought (to choose one among endless such examples) when Bill Clinton said he would subsidize the wages of mothers leaving welfare to encourage employers to hire them, but then offered a tiny fraction of the funding needed to give 4 million ill-equipped welfare moms a shot at permanent work? Should we have applauded the president for making a nod in the right direc-

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tion? Or damned him for falling so far short of what was needed while pretending to deliver?

Our founding fathers designed a government of diffused powers. Its natural tendency is gridlock. Politics has always to some extent involved choosing the caricature of reality that most closely approximates our values. But our predicament today is different and troubling in two ways.

First, our two major political parties are organized around ideologies and interest groups that systematically ban commonsense, well-funded policies that blend liberal and conservative ideas. Suppose, for example, you look at the uninsured and think money is the answer ("liberal"), but you also think government should basically give people who need it the money to buy private coverage themselves ("conservative"). Suppose, like most sensible souls, you think some rules and regulations are needed in this world ("liberal"), but not so much as to stifle innovation and growth ("conservative"). If you're drawn to any of these notions, you're simply too subtle a thinker for what the political establishment says can be safely processed or communicated, or for what well-funded interest groups will allow their hired hands to embrace. But then what?

Thinking Bigger:
Uncle Sam (not your boss) Guarantees a Living Wage

Pat Williams came home exhausted from another 10-hour day in April 2001 to find the note in her mailbox that would swallow her life's savings. The gas company had cut her off because her account was $477 overdue. The 46-year-old single mother had been working at or near the minimum wage in Shreveport, La., for two decades. The nursing home where she worked as a nurse's assistant paid her $5.55 an hour, though she'd been there 10 years and had taken college courses to become certified. She'd started cleaning offices at night for $5.15 an hour – the federal minimum wage – because she couldn't make ends meet.

Not that she could on these two jobs. Williams earned $10,067 in 2000. She also received $2,300 from the Earned Income Tax Credit, the federal subsidy for the working poor, but she was eligible for this much only because she was taking care of her 7-year-old grandson more than half the year. Without that child in her keep, her tax credit would have been just $27, and Williams figured she'd be on the streets. As it was, the unpaid bills piled up. Williams owed $142 to the electric company, $55 to the phone company, $23 on the student loan for those nursing classes, and $40 for her burglar alarm – a necessity in her crime-ridden neighborhood.

Williams dreamed about the breathing room she might have if she could make $7 an hour. But an unexpectedly cold winter had blindsided her. The check she sent to the gas company wiped out most of the tiny nest egg she'd managed to put aside over the years. "It's devastating," she told *The Wall Street Journal*. "You think you're moving forward, but you're just moving backwards."

Few observers would dispute that this is the case for millions of unskilled workers – the maids, nursing assistants, custodians, security guards, food service workers and child- and elder-care providers whose

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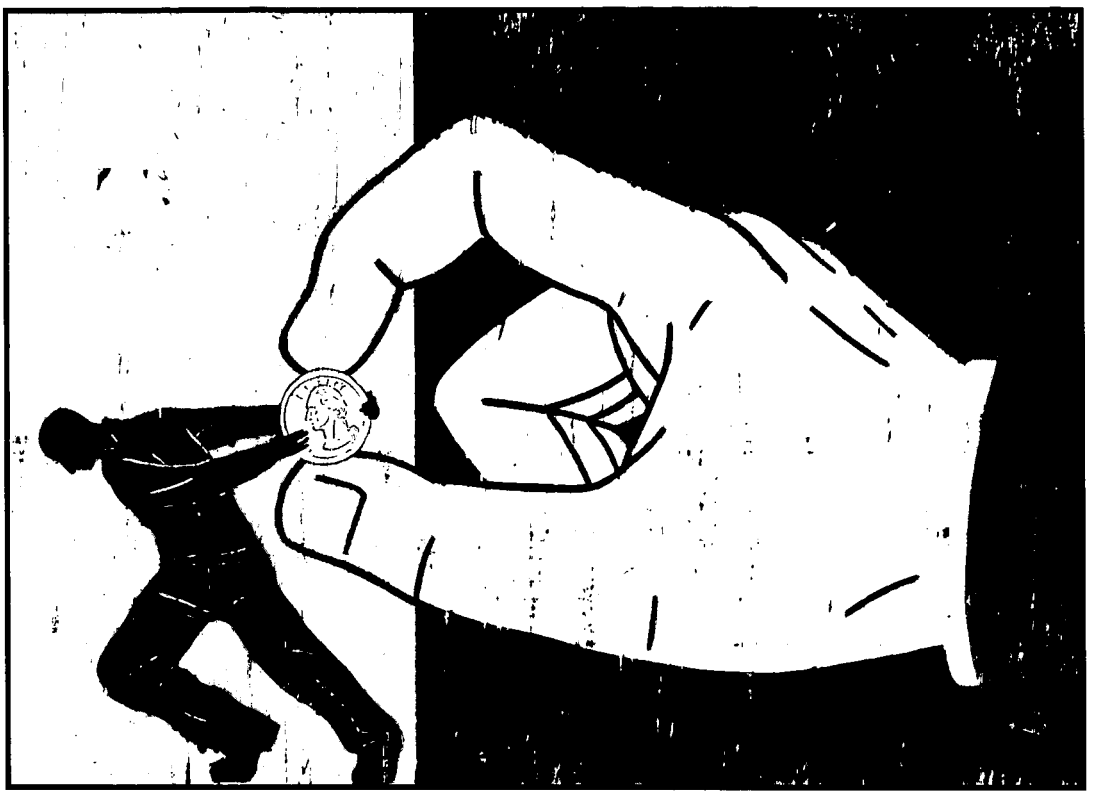

earnings have sagged for two decades while the incomes of college graduates have leapt. Economists say this growing gap between the well off and the working poor – a change from the days when the proverbial rising tide lifted all boats – is due largely to the way technology has reshaped work to benefit Americans with more skills.

The lagging federal minimum wage hasn't helped: at $5.15, it's worth less now, adjusted for inflation, than it was in the 1970s. Union membership declines and rising payroll taxes have also eroded living standards at the bottom; so, too, have trade with less developed countries and an influx of unskilled immigrants. Even in the boom of the late 1990s, which helped many unskilled workers get a toehold in the job market, millions of working-age poor people either never found work or worked too few hours at wages too meager to escape poverty.

These trends converge in ways that mock the value of work. Roughly 15 million Americans dwell in poverty despite living in homes headed by full-time workers – up 50 percent since 1975. Millions more are so depressed by dim earnings prospects that they've stopped looking for work altogether. "Employment opportunities for the less skilled are not what they used to be, so people just leave the labor force," Robert Topel, an economist at the University of Chicago, has explained.

The portion of male high school dropouts who have simply dropped out of the workforce (or who can't find jobs despite trying) has doubled since the mid-1970s. It can't be a coincidence that this wage and employment meltdown for the unskilled has been matched by rising crime, illegitimacy, drug use and prison rolls, which together have spawned

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vast urban wastelands and a generation of ghetto kids with few models of normal social life revolving around work. Welfare reform, meanwhile, has turned several million welfare mothers into an equal number of working-poor mothers, helping explain why visits to soup kitchens more than doubled from 1997 to 2001.

What to do? The usual catalog of remedies is well meaning. Improve education and job training. Reform labor laws, which now let employers fire unionizing workers with impunity. Lower the rate of legal immigration while shifting the immigrant mix toward better-skilled workers who don't compete with the native-born working poor. The trouble is that these steps could take years, even decades, to make a dent; or that they address too small a piece of a broad problem to be sufficient. Meanwhile, the debate over a "living wage," is caught in an unproductive rut.

The right wants to kick out social supports and force people to work, without acknowledging that abysmal wages for the unskilled leave them prey to the same social problems as when they were on welfare. The left cries for mandated "living wages" far in excess of what many less-skilled workers are worth to employers, thus ensuring they won't be hired. Isn't there anything we can do now that doesn't consign today's luckless workers to lives of not-so-quiet desperation – and thereby complete the unfinished agenda of building a decent society in which work truly pays?

Enter Edmund Phelps, a mild-mannered 71-year-old economist at Columbia University. Phelps first came to prominence in 1968 when, along with Milton Friedman, he fathered the idea of a "natural" rate of unemployment below which inflation is sure to take off. Phelps has devoted much of his time since then to figuring out how to lower this expected jobless rate and improve chances for less-blessed workers. The seed was planted for much of this work in 1969, when Phelps, then at the University of Pennsylvania, wrangled a coveted sabbatical year at Stanford's Center for Advanced Study. Another scholar at the center that year was John Rawls, who was writing *A Theory of Justice* (Belknap Press).

"I had heard the name John Rawls," Phelps told me. "I was told he was something of a prophetic avant-garde moral philosopher, and it was important to understand him."

So when Phelps arrived in Palo Alto that summer and saw there was an open office next to Rawls, he took it. "He gave me some stuff to read," Phelps recalled. "I didn't know quite what to say. It was some stuff about the veil and what these blindfolded individuals would choose to do behind the veil. It got me starting to think, what if they knew that there was a one-quarter probability that they would be blue-collar workers and a one-quarter probably of being something else? ... [But Rawls] didn't want the people behind the veil of ignorance to know what the chances were of being a blue-collar worker or white-collar worker or ditch digger or whatever.... He wanted people behind the veil of ignorance to worry a lot about what would happen if they were in that bottom group."

It turned out Phelps had identified for Rawls the main objection economists would later raise to his theory: why assume that people in the "original position" would be so risk averse? But Rawls' ideas left a profound impression on Phelps. They got Phelps wrestling, unlike many in his profession, with how efficiency (so beloved of economists) could be made to coexist with equity. "It heightened my interest in the high incidence of unemployment at the low end of the labor market," Phelps told me, "and in the problem of low wage rates."

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"From an early time, I read Rawls as making a deep case for redistributive wage subsidies. High wages would be taxed a bit on top of the usual taxes [needed] to pay for national defense and the other basic needs of government in order to provide some wage subsidies at the low end. To this day that's what I think Rawls is basically about."

The years 1969 and 1970 were tumultuous ones on campus. The offices at Stanford where Phelps and Rawls worked were firebombed by radical protesters. Phelps saw Rawls' work as a kind of response to the radicals, who held that capitalism was run only for the benefit of rich and powerful interests. In Rawls' vision, as filtered through an economist's sensibility, America could continue with the capitalist enterprise that had been so rewarding for the majority while at the same time taking modest steps to pull low-end workers up to a more adequate level. By involving them more fully in society's market economy, Phelps reasoned, you might ultimately dissolve America's underclass.

The concerns awakened in Phelps that year percolated for nearly three decades as he built an international reputation in areas such as growth and macroeconomic equilibrium. But Phelps never shook his quiet obsession. He finally outlined his ideas fully in a 1997 book, *Rewarding Work* (Harvard University Press).

Phelps's appeal lies in a non-ideological approach that frees him to debunk everyone's favorite bromide. Phelps can't understand, for example, why liberals always say the answer is to boost various welfare payments, when that only deepens an already corrosive dependency. As proof he offers an astounding comparison: in 1990, the lowest-earning tenth of the American workforce took home $15 billion in wages; meanwhile, total public assistance for health care, housing, food stamps, and related aid benefiting these same families topped $180 billion. Phelps's point is it's not healthy for so big a swath of society to feel responsible for so little of its own upkeep.

But that doesn't mean you pull the rug out. Indeed, Phelps shames conservative purists for their devotion to laissez-faire, which he says not only caricatures the thinking of right-wing heroes like Adam Smith, but also offends all notions of justice. Smith and his progeny, Phelps explains, championed public subsidies to spur the common good (in education, for example). And since the sinking pay of less-skilled workers comes from broad forces beyond their control, Phelps argues, it's immoral to leave such workers languishing – not to mention shortsighted, given the social pathologies that poorly rewarded work breeds.

Phelps's big idea is to guarantee $9 to $10 an hour for full-time work via a sliding-scale tax credit to employers. The "grand bargain" here requires the left to stop trying to place the full burden of a living wage on employers, while the right accepts the need to have government fund the rest. Business should love it, because workers could be hired for as little as $6 an hour, with government putting up $3 to match it. Since the social benefits of work (in terms of less crime, welfare dependency and so on) exceed less-skilled workers' productivity (which limits what employers can offer in wages), it makes sense for society to subsidize the difference.

Say the official minimum wage facing employers is $6. Under his plan, employers would receive a $3-an-hour subsidy from the government (implemented via a rebate against their payroll taxes, perhaps) for every full-time worker they employ at this rate. The system would be designed so that the wage subsidy is passed through to the employee, who would see only the $9 wage in his or her pay. As the wage rate rises, Phelps's sub-

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sidy tapers off, reaching zero around $14 – just above the median wage. The idea is to get less-advantaged workers into entry-level jobs, while helping work pay decently and making it possible for workers to get raises without losing their full subsidy.

There are obviously many permutations through which we could combine the Phelps subsidy and the official minimum wage; the ultimate policy choice involves a balance among (1) the amount we think is reasonable to spend as a nation for these purposes, (2) the new effective minimum wage we want to reach, and (3) what portion of achieving that new minimum we think should be borne by private firms and what portion should be borne by government (a choice that also affects how many low-wage jobs are created).

Phelps's $3 plan, for example, costs about $85 billion a year atop today's $35 billion earned income tax credit (which we would shift to help fund the Phelps subsidy, since the EITC has a similar intent but leaves many low-wage workers – especially those who are childless – outside its coverage). We could apply the same $3 Phelps subsidy to today's $5.15-an-hour federal minimum wage and create an effective minimum of $8.15 for the same national "price"; and we could raise the minimum wage to $7 (as most liberals want) and put a $3 Phelps subsidy atop it to get to a $10 wage for this price, too. Alternatively, we

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could raise the minimum to $7 and apply a $2 Phelps plan to reach $9, but for a cost of only about $35 billion a year atop today's EITC. These scenarios suggest how the levers work.

My preference is for the 6 + 3 = 9 plan, but the precise numbers are open to discussion. I came to this exercise with three goals that had to be balanced. First, I originally wanted to reach a living wage of $10 an hour, because I don't see how people can live on less than that (especially in big cities), and because I thought $10 an hour made for the cleanest political rallying cry. My second aim was to keep the minimum wage facing employers relatively low, so as to encourage the greatest possible creation of entry-level jobs that give unskilled workers a way into the workplace and a chance to rise. Third, I had to make sure that whatever resources I devoted to a Phelps-style subsidy left me room to fund the other priorities within the Two Percent Solution. Balancing these goals left me at 6 + 3.

I realize a 7 + 2 option might have more appeal – conservatives will like that the federal cost is far less, liberals will be happy to put more burden on employers, and some states are already close to a $7 minimum wage anyway. But this should be a bargain between left and right that best serves public policy, and if the higher public cost "buys" several million additional low-wage jobs for unskilled workers, in my view, it's worth it. In the end, even though I'm short of my $10 goal, $9 an hour plus basic health coverage is how we'd define the decent minimum in America.

This is a dramatic improvement over the $5.15 to $7 or so minimum we see today (depending on the state) with no health coverage at all. Assuming that a full-time worker puts in 2,000 hours a year at a $6 federal minimum wage, such workers would earn an extra $6,000 a year and have health benefits. For tens of millions of struggling families that will seem like morning in America, indeed.

A senior Bush White House economic adviser told me (not for attribution) that a Phelps-style approach was precisely what we would do "if we were serious."

After raising the minimum wage to $6, I'd also index it (and the Phelps subsidy) to inflation, as Alaska, Washington and Oregon have done. Once we've decided what America's decent minimum should be, why would we purposely let it erode for no reason? The best thing indexing would do is banish the absurd debate ("Why not make the minimum wage $50?" versus "Why not bring back slavery?") we're now forced to endure each time around.

For businesspeople, modest and predictable annual hikes from a low base are better than not knowing when Congress will jerk their labor costs around on a whim. For liberals, an assured boost means less time fighting for basics and more time asking why our economy leaves so many full-time workers on the edge, even after the minimum is indexed. In the end, partisan Democrats may have to make the biggest "sacrifice" by embracing automatic indexing. As things now stand, with Congress needing to act, Democrats are guaranteed a politically potent brawl every few

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years that boosts turnout and reminds voters which side they're on.

Unlike similar-sounding income support schemes like Milton Friedman's "negative income tax," George McGovern's $1,000-a-head "demogrant," or Daniel Patrick Moynihan's Family Assistance Plan, Phelps's subsidy is available only for those who work. Phelps makes the subsidy available only to the private sector; most government wage scales, Phelps reckons, are already padded, since they operate outside markets. Phelps also limits his plan to full-time workers. "If the idea is to promote independence and self-sufficiency," he says, "then you want to restrict it to people who are serious about that as a goal." Unlike today's EITC – which, to limit its cost, is targeted at families with children – Phelps's scheme doesn't leave out millions of disadvantaged and underemployed single males, who are society's biggest troublemakers and are most in need of help to improve their prospects for getting married and supporting a family.

So how have people in power responded to this idea? A senior Bush White House economic adviser told me (not for attribution) that a Phelps-style approach was precisely what we would do "if we were serious." Union officials, reflecting years spent across the table from employers, have a threshold reluctance to the Phelps employer-based approach. "I have a lifelong predilection not to give employers money to subsidize wages," said Tom Donahue, former president of the AFL-CIO.

It lets them off the hook, he said, for paying a decent wage themselves. But Donahue also acknowledged that at some point higher mandated wages cost jobs. Donahue told me that while his instincts led him to prefer that any bigger subsidies go to individuals via EITC expansions, he wouldn't want to oppose the Phelps approach, because reframing the debate around what the nation needs to do to create a decent reward for work is "exactly where we need to go."

Left-leaning economists, such as Jared Bernstein of the Economic Policy Institute [see page 26 of this issue], think getting to $9 an hour would be great, but they worry, with Donahue, about letting business shift costs to government that they should bear themselves. They also fret about "leakage" – the prospect that businesses will game the system to capture the subsidy and pad their profits rather than passing it through to employees (by lowering every low-wage worker's pay to the minimum, for example). That's an argument, they say, for giving subsidies to poor workers directly.

Phelps replies that only by subsidizing the employer can you get the new job creation at the low end that brings unskilled Americans into the economic mainstream. Phelps also argues persuasively that because his sliding-scale subsidy preserves wage differentials at every level, employers won't be able to force everyone down to the minimum. More desirable workers who were worth a differential before a subsidy regime is in place (say, the $6.75 versus the $6.00 worker) would still be worth more to employers afterward, and would be competed for, just as in a pre-subsidy labor market.

As with any such program, the potential for fraud is obviously a concern. Firms might try to classify part-time workers or independent contractors as full-time workers to get a subsidy, or cook up other such schemes. But that's not much different from the way firms illegally call workers independent contractors today to avoid payroll taxes. Fraud and cheating are illegal, just as they are all throughout our complex tax system, and strong enforcement and severe penalties would be needed.

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Conservatives also rightly raise the question of how this plan would deal with immigrants: it can't be the case that you can get off the bus from Mexico and be entitled to a $9-an-hour job. They're right, of course, and so eligibility would have to be restricted to American citizens, or perhaps to those legal immigrants who have been here for some period of years. Contrary to what many conservatives assume, however, just one in four poor workers are recent immigrants. About a quarter of America's poverty-level work is a function of being an open society; there are millions upon millions of Pat Williamses in our midst.

The main objection to Phelps's idea is cost. As mentioned, the Phelps plan would cost roughly $85 billion a year atop today's EITC. That's a fortune compared to today's political debate, but it's less than a penny in the two cents on the national dollar we've been discussing.

Phelps, in fact, argues that any new financing would be transitional; before long, he says, the wage subsidies would pay for themselves, given the cuts in myriad welfare, police, and court costs that would come as work became the norm, along with shrinking unemployment benefits and higher tax revenues from workers and corporate profits.

Money aside, in the end a Phelps-style subsidy really amounts to a new economic philosophy, a way to marry the efficiency of direct cash payments with the notion of work as the organizing principle for a robust federal commitment to a minimally decent life. It invites public debate to move past isolated and uninspiring squabbles over food stamps and housing vouchers and transportation assistance and child-care credits, and shift to an explicit discussion of how we should define and pay for a minimally decent life for Americans who work.

Nine bucks an hour plus health care! The paradox is that even as this approach honors conservative instincts, it is simultaneously more radical and lefty, because it socializes the cost of the progressive guarantee rather than trying to load it on business, as liberals usually prefer.

The case for serious government action to make work pay via something like the Phelps subsidy draws its ultimate legitimacy from the CEO compensation scandals we've seen these last few years. The conceit, of course, is that top CEOs rake in more than $20 million on average because that's what "the market" demands. If you want Michael Jordan in your lineup, the logic runs, you have to pay what it takes to get him. The reality, however, is that CEO pay is set through a clubby, rigged system in which CEOs, their buddies on board compensation committees and a small cadre of lawyers and "compensation consultants" are in cahoots to keep the millions coming irrespective of performance. Once this veil is lifted, and we realize that CEO pay is set largely by the exercise of institutional power designed to insulate them from market forces, there is no philosophical or ideological reason not to use the same power on behalf of low-wage workers.

The argument generally made against policies like an indexed minimum wage, or wage supplements such as the Phelps plan, is that they represent unacceptable and even dangerous attempts to tamper with markets.

Now we know better.

Combining the power of market incentives to get disadvantaged folks into jobs with the power of American decency to help these jobs pay a living wage doesn't depart from modern capitalism's norms. It democratizes them. After all, if the boss wouldn't dream of having his paycheck determined entirely by the free market, why should the rest of us?

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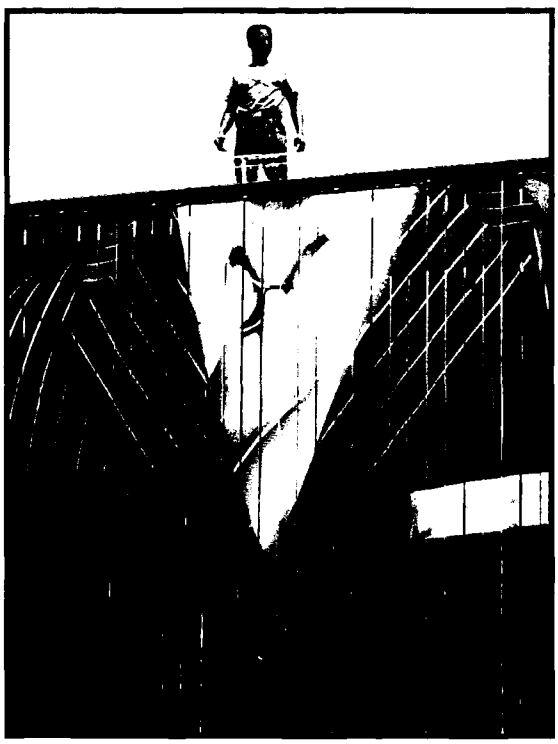
BY JAMES R. BARTH, ROB KOEPP AND ZHONGFEI ZHOU

To call China's economic growth impressive is plainly an understatement. After brushing aside the SARS epidemic, China managed to post its highest growth rate in seven years in 2003 – a robust 9.1 percent. And while many expect this pace to taper off, no reputable estimate puts growth for 2004 below 7 percent.

China's GDP is eight times greater than it was in 1978, when the nation's leadership took the first tentative steps towards a mixed socialist-market system. Measured at current exchange rates, China is already the world's sixth-largest economy. Adjusted for purchasing power, which offers a better sense of domestic consumption levels, China's GDP is second only to the United States' and nearly double that of Japan. It is possible – even likely – that China will be the world's largest economy within a generation.

Beyond the upward trajectory implied by these figures, another reason for such optimism is the relative ease with which China has shed its former economic isolation and embraced global trade. Unlike Japan, which modernized through policies geared for one-way trade, China has adopted a more inclusive strategy. Flexible relationships with foreign multinationals have made it the manufacturing center of the world. By no coincidence, China is also a magnet for foreign direct investment, absorbing $53 billion worth in 2002.



The combination of fast growth and global trade has made the People's Republic of China the world's fifth-largest trading

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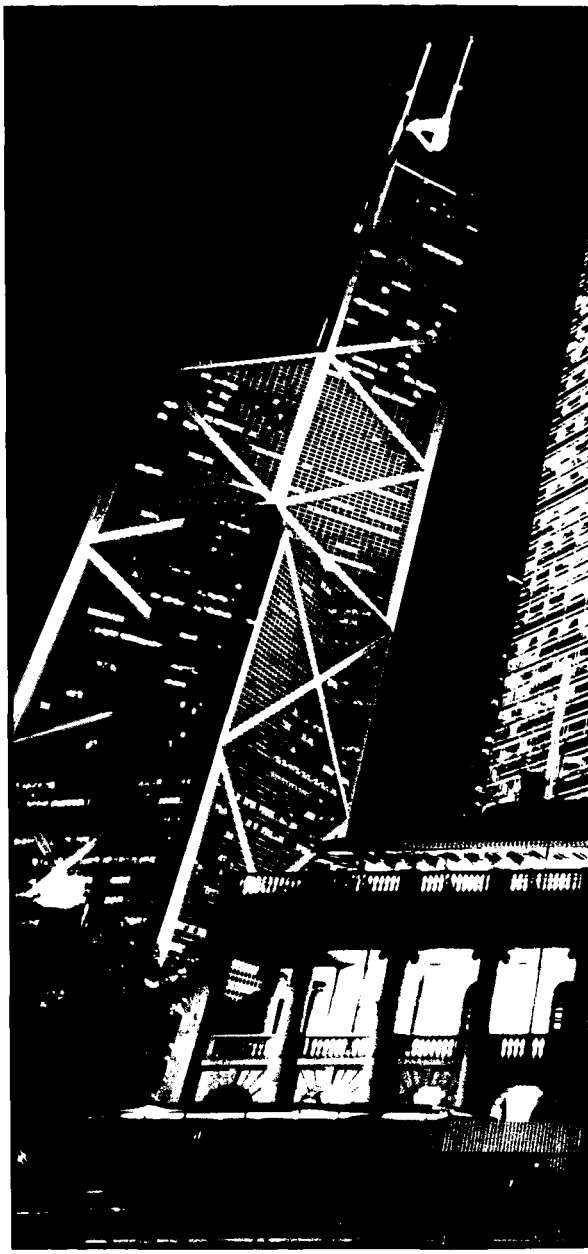
economy. Measured in terms of purchasing power, China accounted for one-third of the world's 3.2 percent growth last year. In 2003, China's per capita GDP surpassed the $1,000 mark for the first time in history. And according to the World Bank, China's more than two decades of market reforms have helped some 250 million of the nation's population rise out of poverty.

The country's growing embrace of global trade is epitomized by its surprisingly rapid accession to the World Trade Organization. With China's WTO membership in 2001, the national leadership embraced a variety of challenges – among them opening the country's financial-services industry to foreigners by Dec. 2006. The deadline means a lot of change, quickly. The most significant change will occur in banking. Like most of their counterparts throughout East Asia, businesses in China are heavily dependent on bank financing, rather than on the issuance of marketable securities. Yet banking is a glaringly fragile component of the Chinese economy. A half-century of uncompetitive lending to state-owned industry has left a massive deadweight of nonperforming loans. And lately it has become fashionable to predict that China's nonperforming-loans problem will gradually eat away at the economy's performance, if not stall growth entirely.

While pessimists are right to be concerned, they ignore the potential upside from successful banking reforms. Indeed, we believe that China's banking sector has the potential to catalyze the next steps in the economy's ongoing transformation.



CHINA'S FINANCIAL SYSTEM

Banking assets make up nearly 80 percent of the nation's financial-asset pie. The market capitalization of equities listed on China's Shanghai and Shenzhen stock exchanges (setting aside Hong Kong, the only two in the country), account for just 15 percent of financial assets. And even this modest figure is misleadingly high, because two-thirds of China's listed shares are government-owned and thus not tradable. The percentage of

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external funds raised by corporations issuing bonds is lower still, amounting to less than 1 percent of the total.

China's financial asset base is equivalent to 244 percent of GDP; the figure for the United States is roughly the same, at 236 percent. Yet the composition of the bases differs in telling ways. America's financial infrastructure is dominated by securities markets. Firms in the United States have a variety of choices for raising external capital – issuing stocks or bonds, or borrowing from banks. Thus, when one source of funds is impaired, other options remain. In the face of a banking crisis,

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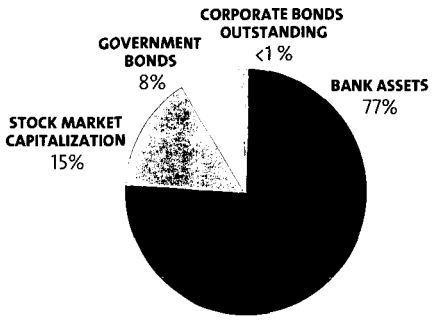
CHINA'S BANKING REFORM

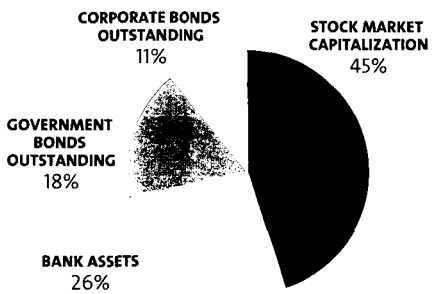
SIZE AND COMPOSITION OF CHINA'S FINANCIAL SYSTEM – 2002

TOTAL = $3.1 TRILLION



SIZE AND COMPOSITION OF THE UNITED STATES' FINANCIAL SYSTEM – 2002

TOTAL = $24.7 TRILLION



for example, firms could still obtain investment funds through the securities markets. Stockholders and bondholders, moreover, provide not only capital but also a valuable source of discipline. Their investment decisions help ensure that only firms with productive investment projects receive funding, and use the invested funds as intended.

Beijing recognizes the value of such financial diversity. To that end, it established the mainland's two stock exchanges back in 1990-1991, and since then the exchanges have facilitated the conversion of state-owned enterprises into stock companies. Public trading of such privatized enterprises has enabled firms to mobilize valuable capital for restructuring. Trading in company shares has also created pressure to make corporate activities more transparent and to make corporate officers more responsive to stockholders' interests.

Later reforms have brought China's financial infrastructure still closer to that of the market economies. Among the recent notable initiatives is the Qualified Foreign Institutional Investor program, introduced in late 2002. Under that program, foreign institutions receive a foreign-exchange quota to be applied to securities investments. As of Jan. 2004, the State Administration of Foreign Exchange granted foreign-exchange quotas, totaling $1.7 billion, to 10 of them. This is a modest beginning. But at least six additional overseas institutions have applied for new qualified foreign institutional investor licenses, and several existing license holders are applying for quota increases. UBS, for example, exhausted its $300 million limit and has obtained permission for increasing it to $600 million. The program's success has already led to talk of a Qualified Domestic Institutional Investor program, which would allow China's own institutions to invest in overseas capital markets and build closer ties to foreign enterprises.

The country is also emerging from a state-decreed moratorium on corporate bond issues that followed a spate of defaults by state-owned enterprises during the late 1980s. As the drive for financial liberalization was gaining steam in 1999, the moratorium was eased, and since then the market for new corporate debt has revived modestly. Although this market remains very small, it has the potential to expand if easing continues. One area for further liberalization is the regulated ceiling on interest rates for corporate debt, irrespective of the issuer's credit

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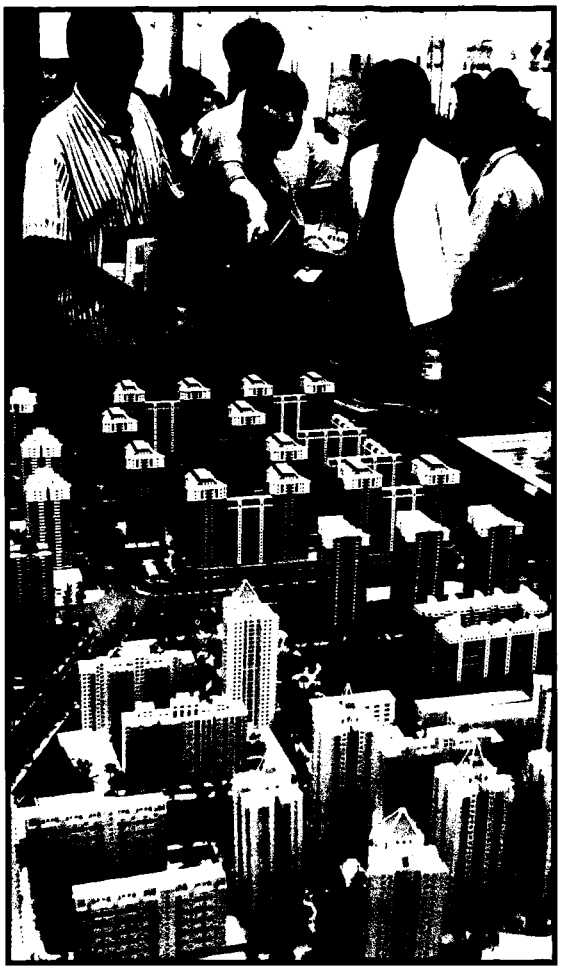
quality. Another is the requirement that individual bond issues be approved by an arm of the State Council, the top executive organ in China.

SIZE MATTERS: CHINA'S BIG FOUR

The dominance of banks over capital markets in China is a fact of life. Accordingly, the pace of financial reform in China will depend on the nature and timing of bank reform.

Indeed, the effects of that dominance and the critical importance of reform are compounded by concentration within banking. There are 36,611 banking institutions in China. The vast majority (98 percent) operate as mutual institutions known as rural credit cooperatives, which dot China's 25,000 townships. Despite their numbers, though, the cooperatives account for only 10 percent of total bank assets. The real money is in China's four enormous state-owned banks. The Big Four hold 59 percent of all bank assets and operate a nationwide branch network. Given the dominance of banking assets in the financial system as a whole, this means that the Big Four account for about half of the financial assets of the nation. China thus does not merely have a financial infrastructure dominated by banks, but rather one dominated by just four banks.

The story of how the Big Four grew preeminent is important to understanding the recent changes to the system and the direction in which reforms are heading. The state-owned banks were born from China's first stage of financial reforms, orchestrated by Deng Xiaoping in 1979. After the 1949 revolution, the Communist government gradually closed China's patchwork of commercial banks, replacing them with a single People's Bank of China. Thereafter, the bank played a dual role as both a central bank and commercial bank. It wielded monopoly power, disbursing investment and operating funds to state enterprises according to government fiat.



AP/WIDE WORLD PHOTOS

Deng's reforms brought the first break in the People's Bank of China monopoly, first spinning off the Agricultural Bank of China and then the Bank of China. For the Agricultural Bank the spinoff was really a rebirth, as it had operated independently before being merged with the People's Bank of China in 1957. The Bank of China was created by carving out the People's Bank of China's foreign-exchange division. Within a matter of years, the State Council decided to reconstitute the People's Bank of China to serve solely as the

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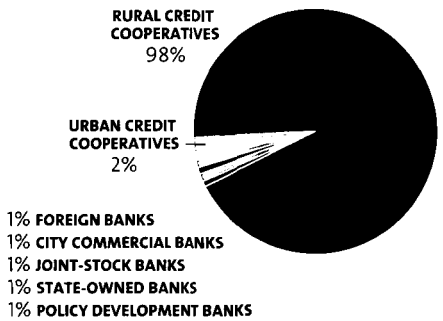
CHINA'S BANKING REFORM

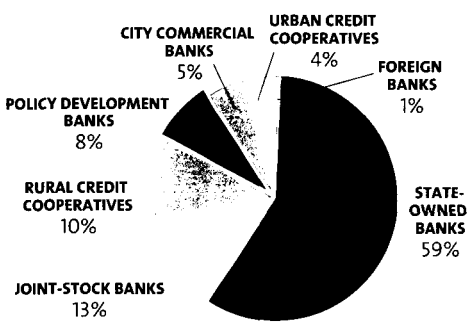
NUMBER AND TYPE OF BANKING INSTITUTIONS IN CHINA - 2002

TOTAL = 36,611 BANKS



TOTAL AND COMPOSITION OF BANK ASSETS IN CHINA - 2002

TOTAL = $2.7 TRILLION



nation's central bank. It transferred the bank's remaining commercial banking functions, along with certain other banking functions, from the Ministry of Finance to two special-purpose banks: the China Construction Bank (formed in 1983) and the Industrial and Commercial Bank of China (1984). Thus the People's Bank of China was oriented toward functioning as a genuine central bank, and China's two major state-owned commercial banks were turned into four.

The dominance of the Big Four in China's financial system today can easily leave the impression that they are a monolith, a holdover from the days of central planning. In fact, they represent the first major effort to harness market forces to discipline banking practices. The fundamental problem left unsolved has been the state-owned banks' ongoing lending to inefficient, financially unsound state-owned enterprises. This bureaucratic-industrial lock has impeded the development of a credit culture – an appreciation for balancing risk and return considerations – in reaching lending decisions.

Despite the obstacles posed by the legacy of China's bureaucratized banking, Beijing has persisted with liberalization. In 1994, the Big Four were recast as commercial banks and three new policy-development banks were established: the China Agricultural Development Bank, the China Development Bank, and the China Import and Export Bank. The policy banks were specifically created to divorce the state-owned banks from responsibility for lending dictated from above, enabling them to act more like true commercial banks. However, while the policy banks do issue bonds ($109 billion outstanding as of year-end 2002) to support lending, most of these bonds are purchased by banks – particularly by the Big Four.

In 1995 there was another major reform, the adoption of the Law of the People's Bank of China and the Commercial Banking Law of China. The former solidified the People's Bank of China's status as China's central bank and made it the chief regulator of the banking system. The latter brought the Big Four a step closer to operating like commercial banking enterprises by giving them greater autonomy. It also introduced prudential standards and regulations for the industry. The greatest contribution of this round of reform was to promote a market-driven banking system and, more generally, to advance the rule of law –

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Key Events in the Development of China's Banking System

1948 People's Bank of China established.

1951 *Renminbi issued as new currency.*

1978 Vice Premier Deng Xiaoping begins the process of transforming China from a centrally planned to a socialist market economy.

1979 The People's Bank of China's banking monopoly ends with the formation of the first two state-owned banks of the Big Four: the Agricultural Bank of China and the Bank of China.

1980 China resumes its membership in the World Bank and returns to the International Monetary Fund.

1983-4 The next-two state-owned banks of the Big Four are created: the China Construction Bank and the Industrial and Commercial Bank of China.

1985 *China approves establishment of the first foreign branch bank office in China since 1949.*

1990 Shanghai Securities Exchange established.

1991 Shenzhen Securities Exchange established.

1992 China Securities Regulatory Commission established.

1994 The Big Four are recast as commercial banks; three new policy-development banks are established: the China Agricultural Development Bank, China Development Bank, and China Import and Export Bank.

1995 National People's Congress passes the Law of the People's Bank of China, codifying the People's Bank of China as China's central bank.

National People's Congress passes the Commercial Banking Law, enabling the Big Four to become genuine commercial banks; the law also segregates the business operations of banks, securities firms and insurance companies.

1996 China Minshen Banking Corp., the nation's *first publicly traded private bank, established.*

1998 China Insurance Regulatory Commission established to take over regulation of the insurance industry from the People's Bank of China; the China Securities Regulatory Commission takes over supervisory responsibility of securities market regulation from the People's Bank of China.

Big Four infused with $33 billion of capital.

1999 China's first bankruptcy of a major financial institution: Citic.

Four asset-management companies established to offload $169 billion in nonperforming loans from the Big Four: China Xinda, China Oriental, China Great Wall, and China Huarong.

2001 China becomes a member of the World Trade *Organization; commits to opening up its* financial services industry to foreign banks on equal terms by 2006.

HSBC Holdings becomes the first foreign bank to buy a stake in a mainland Chinese bank.

2003 Law of the People's Bank of China and the Commercial Banking Law of China amended; Law on the Supervision of the Banking Industry passed; the China Banking Regulatory Commission legalized and the People's Bank of China further empowered as the nation's central bank.

State Council approves Reform Measures for Rural Credit Cooperatives, thereby promulgating reforms on supervision, ownership, policies and operations.

$45 billion injected into the China Construction Bank and the Bank of China, two of the Big Four considered to be the least burdened by nonperforming loans.

Measures for the administration of equity investment made by overseas financial institutions in Chinese-funded financial institutions take effect on Dec. 31. The amount of equity investment allowed to be made by foreign financial institutions in Chinese financial institutions is increased to a maximum of 20%.

2004 Three major new financial laws implemented: Law of the People's Bank of China (amended), Administrative Measures on the Supervision of the Banking Industry, and Commercial Banking Law of China (amended).

both crucial components in liberalizing China's economy overall.

In the aftermath of the 1997 Asian financial crisis and fears it might spread to China, Beijing made further reform of the banking system a strategic priority. Originally, the People's Bank of China had been responsible for banking, securities and insurance. In 1998, supervision of the latter two sectors was transferred to the China Securities Regulatory Commission and the China Insurance Regulatory Commission, respectively.

Coincident with these moves, the central government publicly owned up to the banking

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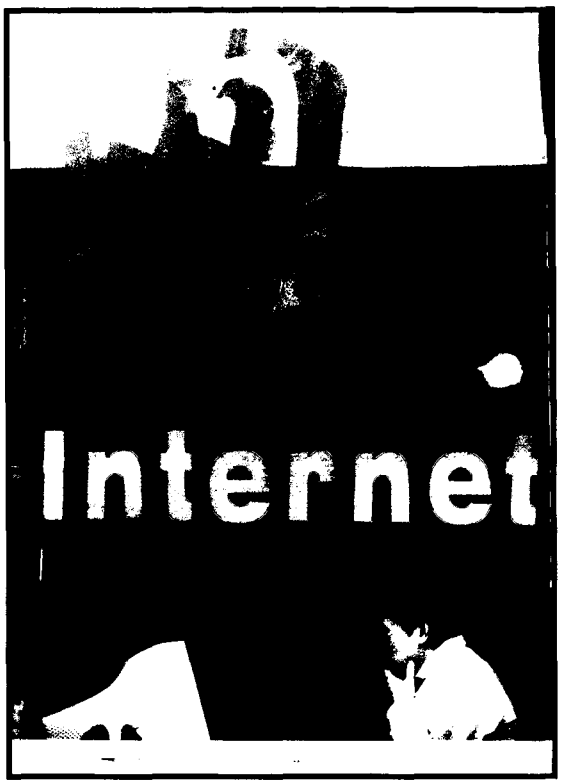

system's grossly unhealthy balance sheet, injecting $33 billion of capital into the Big Four. Shortly thereafter, it took the added step of establishing four asset-management companies, one for each of the banks. The companies eased pressure from the banking system by absorbing $169 billion in nonperforming loans. By the end of 2003 they had disposed of $61.5 billion in bad loans, recovering some $12 billion. Although this represents a recovery rate of only 20 percent, it nevertheless was a significant step toward bolstering the nation's fragile banking system. The Big Four have formally acknowledged that more than one-fifth of their loans are nonperforming, a figure that translates to some $250 billion in bad debt. Unofficial estimates have put the figure as high as $470 billion.

If one assumes a recovery rate of 30 percent for the disposal of these assets, the scope of the liabilities problem at the Big Four ranges from $177 billion to $329 billion, or 15 percent to 27 percent of GDP. The alarming scale of China's nonperforming loan problem (which is even larger if other types of lenders are included) explains why the banking system is both China's core financial asset base and the Achilles' heel of its booming economy.

ONGOING REFORM

Just last year the government created the China Banking Regulatory Commission, one of many initiatives narrowing the focus of the People's Bank of China so that it can better serve as the central bank. The Commission's creation completes the transfer of the People's Bank of China's all-encompassing regulatory powers over the financial-services industry, reflecting the function-based approach China is taking toward financial-services regulation. The People's Bank of China is now structured to concentrate on monetary policy, avoiding the potential for conflict with the role of overseer of the commercial banks.

At the end of 2003, the government injected another $45 billion into the big banks, with equal portions going to the China Construction Bank and the Bank of China. These are the two major lenders least burdened by nonperforming loans, and they were selected in a pilot program to test the viability of transforming the state-owned banks into internationally competitive joint-stockholding banks. Both banks are expected to go public by 2005, and already have important alliances with foreign banks in place.

The capital infusion came from China's awesome foreign exchange reserves which, even after the transfer, stood at $403 billion, thanks to China's cumulative trade surpluses. Rather than exchanging bad loans for bonds, as was done previously, the latest capital infusions have come as pure cash transfers. This has increased the banks' capital-to-asset ratios,

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giving them incentives to make more-prudent loans, which in turn should help reduce their nonperforming-loan ratios. Some $40 billion and $35 billion have reportedly been earmarked for the Industrial & Commercial Bank of China and the Agricultural Bank of China, respectively – the Big Four banks most burdened by uncollectible debt.

room for expanding into non-banking businesses in securities and insurance. This holds out the promise for increased profitability and greater risk diversification.

WHAT MUST BE DONE

While there is certainly good reason to believe that China is making progress in getting its financial house in order, criticisms of banking reforms remain. These typically boil down to claims that deregulation and efforts at addressing the nonperforming loans are insufficient to deal with the sheer magnitude of the problems. For example, the use of the nation's swelling pool of foreign reserves to offset nonperforming loans is seen as both a ploy for delaying the banks' day of reckoning and a way to ease pressure on China to appreciate its currency. Moreover, with economic growth near 10 percent, loans that have been directed to especially frothy sectors like real estate could further burden an already troubled banking sector when the cycle turns downward.

With economic growth near 10 percent, loans that have been directed to especially frothy sectors like real estate could further burden an already troubled banking sector when the cycle turns downward.

In addition to the capital injections, the National People's Congress passed three banking laws that took effect in February. One solidifies the People's Bank of China's responsibility for making monetary policy, guarding against financial risk, ensuring financial stability and combating money laundering – as well as confirming that it will no longer regulate financial institutions.

The second law, the Law on the Supervision of the Banking Industry, complements the first by assigning the China Banking Regulatory Commission's responsibility for regulating all banks and other depository institutions. This law also introduces some of the international norms for banking supervision, designed to steer banks towards better risk management. Yet another law frees the Big Four of obligations to grant loans for projects approved by the State Council. It also gives banks authority for activities taken for granted in advanced economies: trading government bonds, dealing in foreign exchange, and offering payment card services. Although banks are prohibited from investing in non-banking financial institutions, the laws leave

While there may be some truth here, other considerations suggest that the ongoing banking reforms will have a lasting impact. The value of the latest round of recapitalization is indeed dwarfed by the magnitude of nonperforming loans. Yet the Big Four still have ample reason to put the capital infusions to good use as they prepare for competition with foreign banks. Exchange-rate considerations may well have influenced the decision

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to use foreign reserves to fund the capital infusions. But arguments that the exchange-rate policy is dictating the agenda for banking reform are unconvincing.

The more legitimate concern is potential overheating in the economy. Rapid growth in money supply and credit may be leading to overinvestment – and excess capacity – in some industries. Both credit and money grew by more than 20 percent in the first half of 2003, the most since 1998. Here again, however, the government seems to be responding appropriately. For example, it has hobbled liquidity creation by increasing the percentage of deposits banks must hold on reserve. As a consequence, bank loans increased by only $9.9 billion from October to November 2003, a dramatic contrast to the average monthly increase of $33.2 billion during the first three quarters of 2003. Nevertheless, if growth in money and credit is not checked, it will undoubtedly add to the precariousness of China's troubled banking sector.

THE BIG PICTURE

During the past quarter-century, China has taken major steps to convert a centrally planned economy into a market-oriented one. This has included spinning off the commercial banking operations of the People's Bank of China into separate commercial banks, improving financial supervisory authority, generally strengthening the rule of law in the financial system, and taking related actions to foster a modern credit culture. The nearly $250 billion the government has pumped into the Big Four demonstrates that Beijing is doing more than just talking about bank reform. While by no means guaranteed to stay on course, the momentum and trajectory of China's banking reforms do suggest that nonperforming loans will eventually be reduced to levels manageable by the banks themselves.

Furthermore, China's increasing integration with the global financial system has increased the sense of urgency for resolving nonperforming loan problems. As of late 2003, there were 62 foreign banks from 19 countries with 211 representative offices in the People's Republic. Currently, these banks account for a mere 1.4 percent of total banking assets. But once China's financial sector is opened to foreign banks on more equal terms, the proportion of assets held by foreign institutions surely will increase.

China has a national saving rate of around 40 percent of GDP – a remarkably high level. Most of the savings is in banks, which held $1.25 trillion in household deposits at the end of 2003. The magnitude of these assets, combined with the opportunities implied by China's economic mass, continued growth and rising personal income levels, means that foreign financial institutions will continue to make China a major target.

The resulting competition in the banking sector should eventually mean that Chinese households and businesses benefit from more competitive interest rates on loans and deposits and a wider range of financial products and services. There are encouraging signs that this is already underway: since the beginning of 2004, the People's Bank of China has allowed banks greater leeway to raise their lending rates to reflect actual risk.

To be sure, banking reform is a work in progress; its final contours are still being determined. But so far, the leadership's demonstrated commitment, combined with the inexorable pressures associated with opening up to foreign competition, suggest that what so far has been the weakest link in the world's hottest economy may soon be one of its strongest. M

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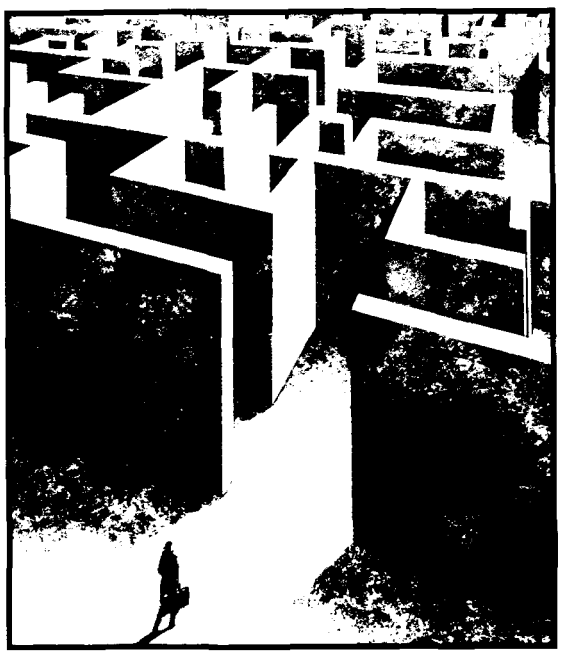
BY GARY S. BECKER

A well-known physician who was suffering from a serious illness once told me not to take too seriously what doctors tell patients they would do if they had the patients' diseases. After his illness was diagnosed, he became convinced that no doctor, no matter how experienced and well intentioned, could really put himself or herself in a patient's shoes.



Treatment of serious diseases usually offers options that trade off various risks, for example, forcing comparisons between the likely quality of life and its expected length. No one is really able to read the thoughts of others well enough to make informed decisions on their behalf. This is why patients – not regulators or even physicians – should have ultimate control over treatment.

I mention regulators because government authorities, in particular the Food and Drug Administration, make it extremely difficult for the very ill to gain access to unproven therapies. This barrier became more daunting when the FDA instituted regulations in 1962 that significantly raised the cost and lengthened the time it takes to bring new drugs to market.

Before that year, pharmaceutical makers had to show only that drugs appeared to be safe for the vast majority of patients likely to take them. Assuring safety required clinical trials along with other evidence and was not an easy obstacle to overcome. But I do not want to argue here the issue of how safe is safe enough, and I assume that an FDA safety standard, perhaps even a strengthened one, is desirable.

The 1962 regulations, however, went beyond safety to add an efficacy standard. That is, clinical trial evidence would from then on have to strongly support claims that products significantly aid in the treatment of specific diseases or conditions. Indeed, in the final stage of mandated clinical tests, randomized

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trials must show that those treated with a drug are significantly helped compared with a control group.

This efficacy test greatly lengthened the average time between discovery and approval. Although in recent years the FDA has maintained a "fast track" for high priority drugs, bringing a new therapy to market takes an average of 12 to 15 years. The typical drug must be tested on some 6,000 patients, increasing total development costs by about 40 percent.

Many people whose lives are at risk want to believe that they ultimately make the decisions – even when they essentially follow the experts' advice.

It follows that a return to a safety standard alone would lower costs and raise the number of therapeutic compounds available. In particular, this would include more drugs from small biotech firms that do not have the deep pockets to invest in extended efficacy trials. And the resulting increase in competition would mean lower prices – without the bureaucratic burden of price controls. In turn, cheaper and more diverse drugs would induce insurance companies and public providers to cover many more new drugs, even when their efficacy was uncertain.

Elimination of the efficacy requirement would give patients, rather than the FDA, the ultimate responsibility of deciding which drugs to try. Presumably, the vast majority of patients would continue to rely on the opinions of physicians about which drugs to use. But many people whose lives are at risk want to believe that they ultimately make the decisions – even when they essentially follow the experts' advice.

To be sure, some sick individuals would try ineffective treatments that would otherwise have been prevented from reaching market under present FDA regulations. But the quantity of reliable health information now available with only a little initiative is many times greater than when the efficacy standard was introduced four decades ago. WebMD and other Internet sources, along with better and more extensive health reporting by the news media, offer medical consumers superior access to information than even their doctors enjoyed not long ago.

As part of any relaxation of the efficacy standard, the FDA could further facilitate public access to relevant information. For example, it could allow drug labels to list separately claims that are supported by clinical evidence and those that are not. And it could be proactive in reporting what is known about the value of drugs in treating diseases, making data available through the Internet and other consumer-friendly media.

One of the more depressing aspects of serious disease is the sense of impotence – that very sick persons can do little to help themselves. This may explain why placebos sometimes generate positive effects. Indeed, Anup Malani of the University of Virginia found that patients receiving placebos in double-blind trials of ulcer drugs reported significantly less pain than they had before the trials.

Giving people whose lives are threatened by serious diseases greater access to safe, promising (albeit unproven) drugs and other treatments would help their psychological state. More important, it would lower the cost and hasten the development of therapies that could really make a difference.

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IT IS ROCKET SCIENCE

Massachusetts, California, Colorado, Maryland and Virginia lead the Milken Institute 2004 Technology & Science Index. The index ranks states based on 75 separate technology and science components.

Ross DeVol, the Institute's director of regional economics and the study's principal author, says research shows that the technology and science infrastructure is more important than ever to economic development – a reality not lost on state policymakers. "There's a real battle going on among the states, because they know how critical it is," DeVol points out.

The ranking appears in two reports: "State Technology and Science Index: Enduring Lessons for the Intangible Economy," which looks at the findings from a national perspective, and "State Technology and Science Index: Comparing and Contrasting California," an in-depth examination of California. Both are available online at www.milkeninstitute.org.

BERNICK ON BOARD

Michael Bernick, outgoing director of the California Employment Development Department, has joined the Milken Institute as a research fellow, focusing on job creation and workforce development projects. Bernick was the head of the EDD from early 1999 through January 2004. His current project areas include skills-upgrading for California's low-wage workforce, the next stages of welfare reform, and job creation for disabled workers.

ILLINOIS DOES DRUGS

The pharmaceutical industry is one of Illinois's most valuable economic resources, accounting for $9 billion a year in Gross State Product (GSP) and more than 100,000 jobs. But the state's position in the industry is slipping, a new study from the Milken Institute says.

The findings bear on the campaign to legalize pharmaceutical imports from Canada, a campaign led by state and local governments eager to reduce their health care costs. "Decision makers need to be aware of how valuable the pharmaceutical industry is to localities," concludes Ross DeVol. "They need to understand both sides – not only how much money they might save, but also how much they might lose."

The pharmaceutical study is available online at www.milkeninstitute.org.

ARKANSAS DOES DEVELOPMENT

The Winthrop Rockefeller Foundation has awarded a $205,000 grant to the Capital Resource Corporation for research aimed at expanding Arkansas's knowledge-based economy. The project's research will be conducted by the Milken Institute in conjunction with the University of Arkansas's Center for Business and Economic Research.

Researchers will examine the state's current economic conditions, assess the comparative position of its industry structure, and benchmark its position in technology and science. Work on the project is expected to be completed this fall.

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LISTS

So what country has the highest living standard in the world?

Probably Norway, which topped the charts in per capita income at $37,783 in 2002 (at contemporary exchange rates). Luxembourg and Bermuda can boast of averages in the mid-40s, but those figures are almost certainly biased by the weight of some very, very rich individuals in the mix.

The lowest rungs on the ladder are occupied by the residents of some remarkably dysfunctional economies. How on earth, you ask, do folks in Ethiopia manage on $90 a year? They don't: translating the value of Ethiopian output into dollars generates virtually meaningless numbers. Suffice it to say, all 10 countries on the list are exceedingly poor.

Perhaps a better one-size-fits-all measure of living standards is life expectancy at birth. But these numbers are also misleading due to the toll of AIDS, which is killing a high percentage of young adults in central and southern Africa.

Which countries are least likely to break out of the cycle of poverty? I'd bet against the countries that discriminate most heavily against women. One revealing measure is the percentage point difference between male and female literacy. And by that criterion, predominately Muslim countries are in for a rough ride.

—Peter Passell

DIFFERENCE BETWEEN FEMALE AND MALE LITERACY
(PERCENTAGE POINTS)

Yemen	42.2
Nepal	35.4
Liberia	33.3
Iraq	31.6
Mozambique	31.3
Guinea-Bissau	30.6
Togo	29.8
Pakistan	29.5
Benin	28.5
Syria	27.9

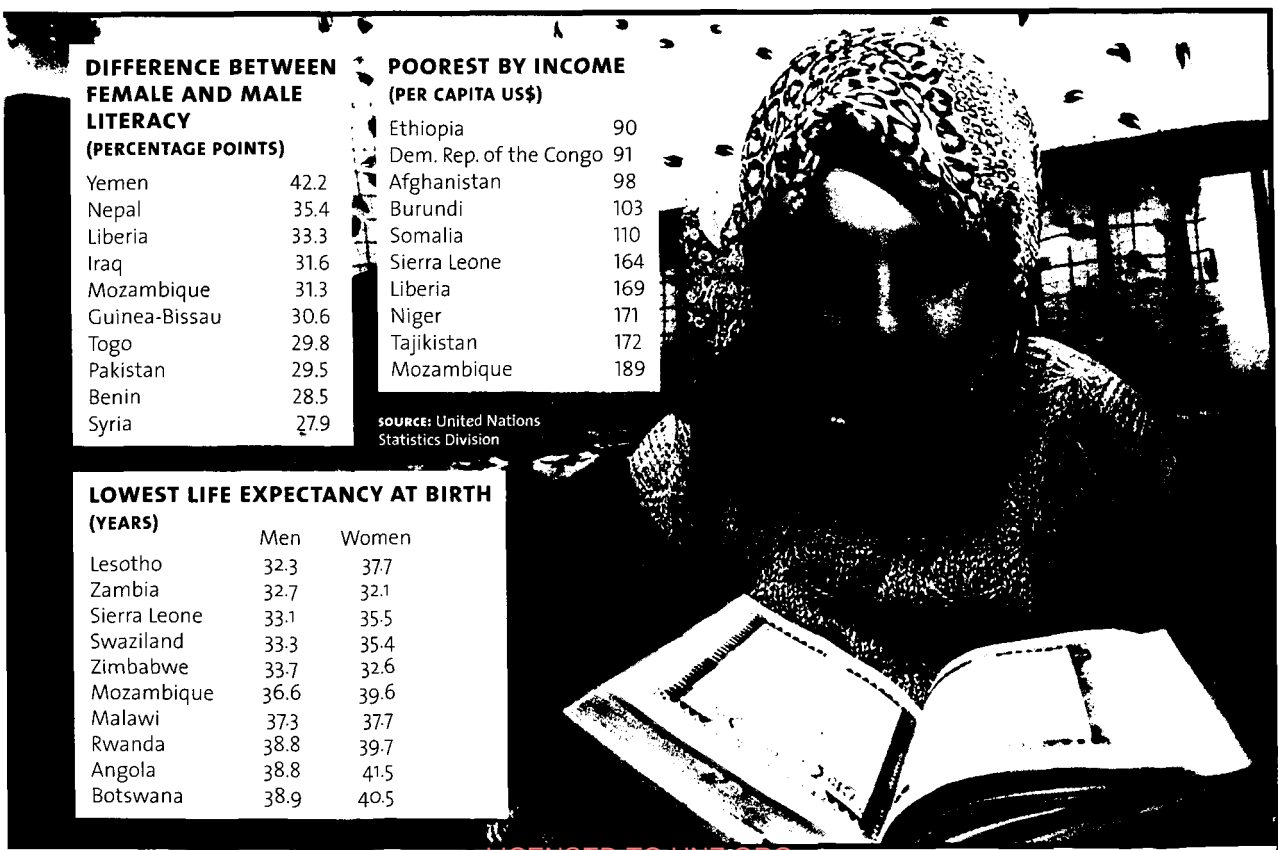
POOREST BY INCOME
(PER CAPITA US$)

Ethiopia	90
Dem. Rep. of the Congo	91
Afghanistan	98
Burundi	103
Somalia	110
Sierra Leone	164
Liberia	169
Niger	171
Tajikistan	172
Mozambique	189

SOURCE: United Nations Statistics Division

LOWEST LIFE EXPECTANCY AT BIRTH
(YEARS)

	Men	Women
Lesotho	32.3	37.7
Zambia	32.7	32.1
Sierra Leone	33.1	35.5
Swaziland	33.3	35.4
Zimbabwe	33.7	32.6
Mozambique	36.6	39.6
Malawi	37.3	37.7
Rwanda	38.8	39.7
Angola	38.8	41.5
Botswana	38.9	40.5



TOP: AP/WIDE WORLD PHOTOS; BOTTOM: ©PAUL A. SOUDERS/CORBIS

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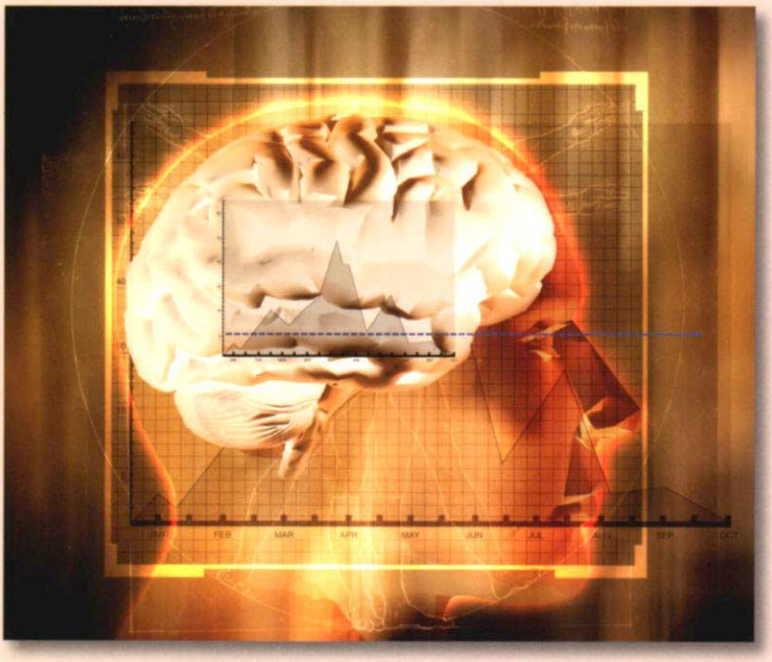
What does a think tank do?



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JARED BERNSTEIN
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JOHN MCDONALD
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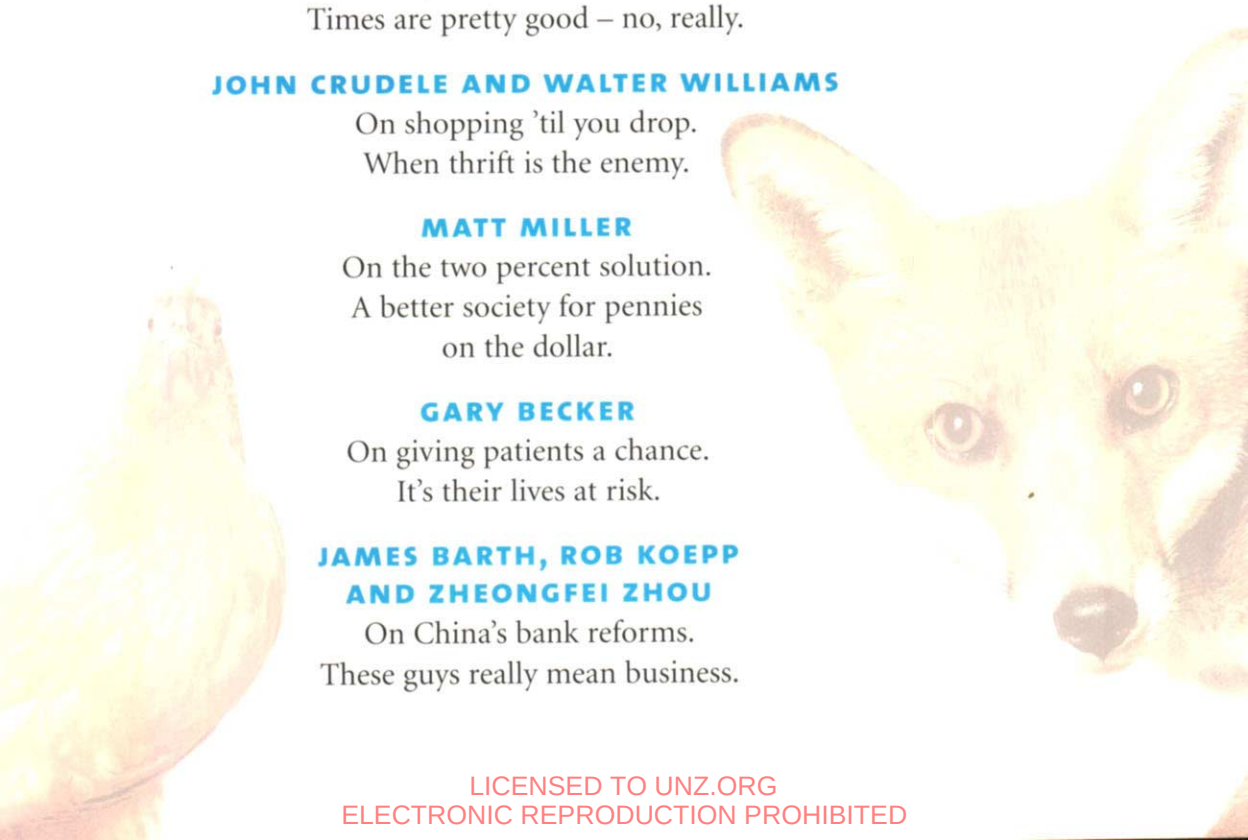
GARY BECKER
On giving patients a chance.
It's their lives at risk.

JAMES BARTH, ROB KOEPP AND ZHEONGFEI ZHOU
On China's bank reforms.
These guys really mean business.



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